

# **An interpretation of equity with special reference to individual tax rates**

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## **ABSTRACT**

The primary aim of taxes is to collect enough revenue to finance public administration and affect redistribution of income especially in developing countries. Ideal tax reform strategies should include tax base broadening, rationalization of tax rates and an overhaul of the tax laws to address the issues of equity, efficiency and simplicity.

Historically, taxation has enjoyed much favour with economists either analysing equity principles or searching for the optimal tax structure. Depending on the affiliations of the economists of the era, tax systems were either progressive or proportional and levied on income or consumption. Early economists raised the issue of equity while efficiency concerns were introduced later and the trade-off between these two principals were analysed to ascertain an acceptable compromise.

The South African tax system has been frequently amended on a piecemeal basis resulting in individual taxpayers contributing proportionally more every year. When equity and efficiency requirements are seen to be lacking, taxpayers may feel aggrieved resulting in non-compliance. Recently personal income tax reform, particularly in the developing world has favoured proportional rather than progressive tax systems. In an effort to simplify their tax systems numerous countries, particularly those situated in Eastern Europe have adopted a version of the Hall-Rabushka flat tax. The adoptive jurisdictions have deviated from the recommended pure consumption based flat rate tax with a basic exemption to a fixed flat rate income tax to satisfy vertical equity principles. Although the flat rate income tax with a basic exemption proved to be the most popular, certain Nordic countries adopted a dual income tax system where capital income is taxed at a flat rate while labour income is taxed at a progressive rate. The resultant increased tax revenues, administratively simple, convenient tax reforms have prompted other developing countries to adopt variations of the flat tax system.

This qualitative study is limited to the current South African personal income tax system and its resultant equity and efficiency consequences for individual taxpayers. The present tax rules encourage tax arbitrage which needs to be rectified. While further research into an improved personal tax system is advised the merits of the flat tax in its various forms should not be ignored.

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# **CHAPTER ONE:**

## **INTRODUCTION AND OVERVIEW**

### **1.1 Introduction**

Albert Einstein commented that “the hardest thing in the world to understand is the income tax” (Goodman, 1997:819). Although income tax is a difficult concept to understand, it is essential for countries to impose income tax on its residents and the non-residents who trade within its borders to function effectively. The degree of complexity of any tax system differs from country to country depending on the policies employed (Bird & Zolt, 2003:5).

Primarily, the need to raise enough revenue for the well-being of the country necessitates an effective tax system (Avi-Yonah, 2006:3). The revenue structure of any country is determined by a variety of factors including the economic principles employed, history and the tax structures of the individual and neighbouring countries (Bird & Zolt, 2008:74; Owens, 2005:4). Although the effects of globalization have influenced tax systems, the size and structure of these are largely dominated by domestic factors (Bird & Zolt, 2008:74). The secondary functions of taxation include a redistributive function which is aimed at reducing any unequal distribution of income and wealth and a regulatory function aimed to steer the private sector activity in a particular direction (Avi-Ronah, 2006:3).

The choice of a tax system, however, is dependent on various factors which range from the level of development, the need for increased public services and the effective administration of the tax system (Bird & Zolt, 2003:5). Featuring prominently are tax policy choices which although extensively dominated by economic principles also reflect political factors and views (Bird & Zolt, 2008:75). As a rule, a good tax system should generate enough income to finance projected government expenditure and comply with the economic principles of simplicity, fairness and administrative efficiency (Owens, 2005:1). These traditional economic principles may further be described as the principles of efficiency, equity and administrability (Avi-Ronah, 2006:1) with a good tax system promoting rather than inhibiting economic growth in a country (Owens, 2005:1) rendering effective tax reform policies vital.

### **1.2 Background to the research area**

The South African tax system prior to the year 2000 was source-based where all residents were taxed on income earned within the Republic. The current South African tax system is based on the residence basis of taxation whereby residents are taxed on worldwide income earned and non-residents only on income sourced within the country (Income Tax Act 58 of 1962,

Section 1). However, income tax rates are not uniform and the current system employed could be referred to as a mixed tax system as both the proportional and progressive tax systems are operational. South African company taxation is based on the proportional tax system while individuals are taxed at a marginal or progressive rate (Aaron & Slemrod, 1999; Income Tax Act 58 of 1962). The rationale behind this system of tax rates is to provide incentives for businesses by allowing multiple deductions and allowances in addition to the flat income tax rate of 28 percent, while individuals are taxed at a marginal rate with certain fixed deductions (Schoeman & van Heerden, 2009:19). An additional dividends withholding tax was introduced where the recipient of the dividend is taxed, in contrast to the previous secondary taxation on companies where the corporate institution was responsible for payment of tax on dividends declared (SARS, 2017:7). This subjects the individual taxpayer to a further tax on dividends earned. A further obstacle associated with a difference in rate structure is the potential migration of highly taxed taxpayers' towards lower tax rates (Gigaba, 2018:12) referred to as tax arbitrage.

Although personal income tax is not levied from the first Rand earned by an individual, no provision is made for the type of income earned with a basic deduction for interest earned per annum being effective (Income Tax Act 62 of 1958, Section 10). Personal income tax exempts an initial amount on tax payable from all taxpayers (the primary abatement) and allows for certain other rebates and relief, a policy that is reviewed annually (Income Tax Act 58 of 1962, Section 10). However, certain developing countries, and a few developed countries, separate labour income from capital income and tax these at different rates (Bird & Zolt, 2011:1693; Genser & Reutter, 2007:436) to ensure a mildly progressive personal income tax with scope for domestic investment possibilities.

Economic principles, political opinions and tax policy should ensure adequate revenue collection to attain the primary functions of tax collection (The Davis Tax Committee, 2014:2). Revenue collection, according to Bird & Zolt (2011:1691), in developing countries are characterised by a major segment of total revenue being collected from corporate rather than individual taxpayers. However, South Africa, being a developing country, relies on personal income tax (PIT) collections, an income tax, and Value-Added Tax (VAT) a consumption tax, both targeted at individual taxpayers (as shown below).

The official statistics for the 2017 and 2018 financial years highlight the percentages of income collected as related to total revenue. Tax revenue collected from individual taxpayers for the 2017 year of assessment (PIT), represents 37,2 percent of the total revenue collected while corporate income tax (CIT) contributed 18,1 percent of the total revenue collected with Value-added tax (VAT) contributing 25,3 percent of total revenue (National Treasury and South African Revenue Service, 2017:17). The 2018 personal income tax collection increased to 38,1 percent

with corporate income tax remaining stagnant at 18,1 percent and VAT contributing 24,5 percent of total revenue (National Treasury and South African Revenue Service, 2018:8). These statistics (National Treasury and South African Revenue Service, 2017:8) further highlight the contribution made by individual taxpayers with the percentage of total revenue increasing from 29,5 percent in the 2007/8 year of assessment to 33,7 percent in the 2011/12 and 34 percent in the 2012/13 year of assessment. PIT collections have increased progressively to 36,4 percent of total revenue in the 2015/6 year of assessment (National Treasury and South African Revenue Service, 2016:18) and further to 37,2 percent of total revenue in 2016/7 (National Treasury and South African Revenue Service, 2017:8). The personal income tax burden in South Africa has increased from 8,3 percent of GDP in the 2010/2011 year of assessment to 9,8 percent in the 2017/2018 year of assessment (National Treasury, 2018:42).

PIT, CIT and VAT collections amount to about 80 percent of total revenue with taxes on other goods and services accounting for the other 20 percent (National Treasury and South African Revenue Service, 2017:1). VAT collections have decreased marginally from 26,4 percent of total revenue in the 2012/13 year to 25,3 percent of total revenue in the 2016/17 year. Although VAT is a consumption tax levied on end users, the scope of this work does not include a study of VAT. However, VAT does impact an individual's tax rate as it is levied post-income tax on goods and services utilized by end consumers, who are natural persons (Bird & Zolt, 2003:7).

These statistics emphasize the increasing burden imposed on individuals due to personal income tax being considered the primary source of revenue collection. The economic effects of this increased burden on individual taxpayers should be assessed to address any shortcomings that may be inherent in the present income tax system and its economic consequences. A study by Macek (2014:324) further verified the negative relationship between economic growth and personal income tax rates.

Taxpayer knowledge in South Africa is rather limited as is its tax base resulting in a small number of taxpayers contributing to the revenue requirements thereby increasing the burden and the tax rate on existing taxpayers with Brodzka (2013) observing:

The narrow tax base often leads to uneven distribution of fiscal burden between economic factors and taxpayers, as a relatively small part of the population is subject to income tax. (Brodzka, 2013:29)

A further impediment to this progressive personal income tax system coupled with the small tax base is the incentive for the proliferation of a shadow economy where individuals avoid paying

tax in numerous ways. This form of tax avoidance is sometimes due to unfavourable tax systems or to ignorance relating to tax issues (Gorodnichenko *et al.*, 2007:1). Tax avoidance in any form leads to a reduction in tax revenue which ultimately results in an increasing shadow economy (Brodzka, 2013:30).

The growth of this unreachable tax base is unfair to the reachable tax base as the outcome is a smaller sector of the population contributing to the total economic activity of the country (Bird, 2003:18; Brodzka, 2013:29). This small tax base feels overburdened by the lack of incentives available and aggrieved by the fact that not all citizens contribute to the welfare of the country (Bird, 2004a:135). The extent of the untaxed economy should be seen as part of the country's tax policy (Bird, 2003:18) with shadow economies around the world ranging from 12 percent in the OECD countries to 44 percent in Africa (Schneider & Enste, 2002:37). The official figures of the shadow economy in South Africa remain unknown as no studies relating to this area have been undertaken and taxpayers are often not candid when confronted with evasion queries, with ACCA estimating a shadow economy of 23,33 percent for the 2017 year with this rising to 24,19 percent by 2025 (2017:11) However, South African tax policy should be actively seeking methods of reducing this unreachable tax base, an area for future research.

### **1.2.1 Tax System Requirements**

Although early economists recognised the principles of equity Adam Smith (1991:498) itemised the four essential criteria for the compilation of a beneficial and effective tax system:

- Equity, i.e. the tax should be fair in its impact to all individuals;
- Clear definition of taxes; i.e. the taxpayer should be certain of the tax liability and method of payment;
- The associated cost of tax collections must be low, both in terms of administration and efficiency;
- Taxes should be collected in a reasonably painless way ensuring a relatively easy way for the taxpayer to settle the tax debts.

Preceding the imposition of any taxes, the definition of income is crucial in defining the base on which taxes should be levied as Armour *et al.* (2013:2) noted that distributional fairness of any tax system is dependent on income and its classification. Early in the twentieth century, two renowned economists developed what is now referred to as the "Haig-Simons" definition of income frequently employed for income tax theory and policy discussion. Both Robert M. Haig

and Henry C. Simons defined income as it should be related to taxation with Haig (1921:27) concluding:

Income is the money-value of the net accretion to one's economic position between two points of time

while Simons (1938:50) deduced:

Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.

This definition of income has been widely used in the United States of America and Canada and has influenced tax base-broadening efforts in these countries (Gale & Samwick, 2014:3). This definition of income as it relates to taxation has often been referred to as the normative standard for income tax in both countries (Duff, 2008:2-3). Most jurisdictions, including South Africa, employ some form of the Haig-Simons definition of income although other definitions of income were forwarded by various economists over the ages (Brooks, 2018:256).

With tax policy being dictated by economic factors, Salanie (2003:59) expanded on the previous two theories suggesting two further criteria when considering taxation policy:

- Taxes should be flexible enough to act as automatic stabilizers to economic fluctuations;
- There should be clarity with regards to who pays taxes.

Tax policy theory should further consider the important economic principle of tax equity which relates to the fair treatment of taxpayers with the same or different income while also providing a screening function whereby non-economic factors are not assessed (Infanti, 2008:3-4). The concept of equity has been dissected periodically with numerous versions of a definition. The most popular being the division of equity into vertical equity which requires that taxpayers with a higher ability to pay taxes should pay relatively more than their counterparts who have a lower ability to pay and horizontal equity which requires that persons in identical circumstances be treated identically (Meade, 1978:13; Repetti & McDaniel, 1993:607-609; Samuelson & Nordhaus, 1989:784; Say, 1971:459; Siddiqi & Gazanfar, 2003:217). Salanie (2003:59) believed vertical equity is present in most tax systems but horizontal equity is lacking.

Economically, equity with related economic factors perform a pivotal role when reviewing tax systems although various non-economic factors have been identified that influence the effective implementation of a successful tax system.

## 1.2.2 Non-Economic Factors

Due to the wide ranging effect tax policy has on any society, it is not unusual to encounter social issues that traverse a range of different disciplines ultimately affecting revenue collection (McKerchar, 2008:5). Macek(2014:311) highlighted the significant influence tax burden places on economic factors and social welfare particularly relevant in developing countries. Although the foremost challenge faced by revenue authorities arise due to compliance issues, Glenday (2008:8) highlighted the importance of personal income tax in the South African context referring to it as the “largest source of tax revenue” while being the “most politically sensitive”. Taxpayer compliance has been analysed at various levels as all revenue authorities share a common mandate of ensuring a high level of compliance. Several tax compliance related South African studies have been undertaken but these have been limited to corporate entities particularly small business entities (Bornman & Wessels, 2018; Smulders *et al.*, 2012). Tax compliance models based on the Fischer model (Fischer *et al.*, 1992) have been reviewed extensively and 14 key factors, subdivided into four groups being identified (Chau & Leung, 2009:34) as being relevant to tax collection.

The formulation of different tax policies together with the infiltration of the shadow economy have resulted in an increase in the number of studies associated with the implementation of revised tax systems globally (Hall & Rabushka, 1995:25; McCaffery, 2002:7; Slemrod, 2006:58). Tax morale issues were empirically evaluated by Vythelingum *et al.*(2017:9) concluding that equity, trust in the ruling government, fairness and social norms impact tax revenue. With economic growth and the resultant fulfilment of social needs being imperative (Macek, 2014:324) a number of countries have converted their tax systems to simpler, economically non-discriminatory systems with remarkable results. The first to introduce a revised tax system in the form of a flat income tax was Estonia in 1994 at a rate of 25 percent, which was subsequently reduced to 20 percent in 2007 (Cassell & Goddard, 2005:10). The flat tax system has been the most favoured due to its transparency and simplicity and has further yielded desirable results in transition and developing countries, the most successful being the introduction of the flat tax in Russia in 2001 (Krivka, 2006:74). A recent introduction of the flat tax system in 2009 has been Mauritius a close neighbour and active trading partner of South Africa (Lam Hung, 2006:27). Although South Africa has a flat rate corporate income tax there have been minimal formal, reported studies on the implementation of a revised equitable and efficient personal income tax system in South Africa. However, studies relating to tax fairness and individual taxpayers have been noted (Viljoen, 2017). Steenekamp (2012:48) observed the empirical evidence relating to the progressivity of personal income tax in South Africa “since

1994 is not very encouraging” with expenditure programmes being far more progressive than the redistributive effects of taxation. Bird and Zolt (2008:81) maintained:

the most effective way to reduce inequality is not through taxation but rather through spending programs targeted at the poor

a theory endorsed by Steenekamp (2012:48).

Although equity forms the basis of this study, other factors related to an economically equitable tax system cannot be ignored especially due to the current South African tax system that employs both a progressive and a proportional tax system dependent on the type of taxpayer.

### **1.3 Motivation and literature review**

Various academic sources have highlighted the factors contributing to a fair and equitable tax system and the related economic and non-economic factors that impact the total revenue received from tax. With the ever-increasing financial demands placed on the fiscus, the need for a tax system that embodies these traits are invaluable however, academic interest in the revision of tax systems for individuals in South Africa has been limited. Steenekamp (2012) in an article titled: *The progressivity of personal income tax in South Africa since 1994 and directions for tax reform* considered a revised tax system for personal income tax only exclusive of a comprehensive study and impact of equity. Equity issues were addressed by Vivian (2006) in *Equality and Personal Income Tax: The Classical Economist and the Katz Commission*, Muller (2010) in *A Framework for Wealth Transfer Tax in South Africa* and Maroun *et al.* (2011) in relation to the fairness of capital gains tax. Although the academic literature has been recently expanded with *An Exploratory Study of the Tax Fairness Dimensions of Individual Taxpayers in South Africa.*(Viljoen, 2017) there remains a caveat in the literature relating to tax reform suggestions which are equity related.

This proposed study would contribute to the academic literature relating to the implementation of a revised personal income tax model in South Africa by investigating the equity and fairness principles related to personal income tax and comparing existing global tax reform models.

National Treasury and the South African Revenue Service statistics demonstrate the reliance placed on individual taxpayers as they provide the bulk of the national revenue in South Africa. This information with the renewed interest in alternate tax systems and the ease at which investors can invest globally necessitates a review of the current tax system and a possible revision of the personal income tax system in South Africa (Steenekamp, 2012; The Davis Tax Committee, 2016).

Global tax reform in the past two decades concentrated on proportional rather than progressive tax systems especially in developing and transition countries which led to rekindled global interest in the Hall and Rabushka flat tax. The original idea based this tax on the principle of consumption, much like the value added tax in South Africa, where taxpayers would be “taxed on what they take out of the economy, not what they put in” (Hall & Rabushka, 1995:52). Although the implementation of the flat tax in the Eastern Bloc countries did not follow the Hall-Rabushka theory completely, the current bout of execution of the flat tax albeit on income (Greenberg, 2009:3) rather than consumption has for the most part proven successful. Various modifications to the basic theory were made to suit the particular country and the appropriate tax laws. Most jurisdictions opted for a flat income rather than a consumption tax (Greenberg, 2009:3; Keen *et al.*, 2008:714)

Various other economically equitable tax methods were explored with McCaffery (2002:6) reviewing a fair tax plan that was not flat tax. This fair tax is referred to as a “consistent spending tax...[with] an unlimited deduction for savings and making other logical corrections” (McCaffery, 2002:6).

Further research into the fair tax principles include the levying of a dual taxation system which taxes investment income at a flat rate while taxing labour income at a progressive rate. Keuschnigg and Dietz (2005:1) further highlight the downfalls of taxing investment income at the identical rate as labour income as a reduction in the volume of investment and savings and relocation of portfolio capital to more favourable tax regimes.

In this light, personal income tax needs to be researched taking into account the vast economic needs of individual taxpayers. Factors that could influence the taxpaying individual include the lack of knowledge pertaining to tax and an intrinsic need to evade tax as individual's perception relating to taxes is deficient (McKerchar & Evans, 2009). The Minister of Finance in his budget speech 2018 cited low taxpayer morale as the leading cause of tax revenue shortfall in the 2017 year of assessment (Gigaba, 2018:13). The general negative attitude towards tax needs to be addressed and a model established whereby the South African personal income tax system is fair and equitable to all its citizens.

An important aspect of this literature review includes a brief overview of the basic economic principles and their relevance to tax which serves to highlight the importance of the principles of equity and fairness through the ages. As developing countries pose unique problems when contemplating tax reforms a brief overview of these will be explored. Shadow economies and their effect on tax policy and an analysis of taxpayer perceptions are investigated as this directly

affects tax revenue collection. Popular tax reform principles of the twentieth century are surveyed and analysed in all their different forms.

### **1.3.1 Economics and Taxation**

Economic interest in taxation is limited to the social policy of measure, utility factors and its equitable justice (Eisenberg, 1934:211). Historically, the need to raise additional revenue prompted the birth of democratic representative governments (Ross, 2002:3) with various forms of taxation being introduced from the Biblical era to the current era (Salanie, 2003:2).

Early economists stressed the principles of equity and neutrality while emphasising principles associated with convenience and productivity (Chapra, 2008:19; Smith, 1991:499). Excessive taxation of the populace is believed to destroy rather than sustain the tax base (Tanwar, 2014:34) and increasing the tax base rather than the tax rate was advocated as a solution to the principles of fairness while encouraging capital formation (Skare, 2013:14).

### **1.3.2 Progressive vs Proportional Tax Systems**

A progressive tax system is believed to create a greater tax burden on affluent taxpayers rather than the low or middle income taxpayers, a principle endorsed by Adam Smith in his *Wealth of Nations* where he stated that tax policy should “remedy inequality of riches as much as possible, by relieving the poor and burdening the rich” (Hosseini, 1995 in Smith, 1776: Bk5; Ch2; Part 2). This principle although widely utilised in the developed world is perceived by some economists and politicians to be counter-productive in developing nations (Browning, 1978:649).

Progressive tax systems tend to encourage the emergence of a shadow economy, with considerable international literature on attitudes of taxpayers towards progressivity as reviewed by Keene (cited in Slemrod, 2006:58) where it was concluded that depending on the construction of the research question, support for a revised tax system, particularly the flat rate income tax, ranged from 27 percent to 62 percent. Slemrod (2006:58) also quoted another American study conducted in April 1999 by Associated Press, which revealed 51 percent of the population agreed that a flat rate income tax with the same tax rate for all citizens was fairer than the current progressive tax rate.

The revival of the age old proportional tax system has been noted in many jurisdictions coupled with many academic studies on this phenomenon.

### **1.3.3 Flat Rate Tax**

With this renewed worldwide interest in a revised tax system, Hall and Rabushka's flat tax theory, first proposed in 1985 gained momentum. Although there was considerable support for this system in the United States of America by politicians (Armey, 1996; Forbes, 2005) this system has not been implemented there but many other jurisdictions adopted a version of the Hall-Rabushka model.

Although the current South African tax system adopts a version of the flat tax for corporate entities, personal income tax is largely a progressive tax. With favourable tax jurisdictions geographically close to South Africa, an examination of the equity principles and possible tax reform methods are strongly advised to prevent tax arbitrage and movement of domestic investment to tax favourable jurisdictions.

### **1.3.4 Other Tax Reform Proposals**

Other tax reform proposals were forwarded to establish a 'fairer tax' system with McCaffery, (2002) and Boortz and Linder (2005:92) suggesting the fair tax, which recommended a system whereby the underground economy, the shadow economy and offshore financial centres are taxed.

McCaffery (2002:97) proposed replacing the "inconsistent income and ineffective estate taxes with a single, consistent, progressive spending tax" which became known as the X-Tax. The X-tax is believed to be economically superior as it taxes consumption rather than capital and labour (Cheney, 2012). Several versions of this X-tax were forwarded by different economists with none being actively implemented.

## **1.4 Limitations**

This study concentrated on personal income tax in South Africa except for a brief discussion on the similarities and differences between the personal and corporate taxation currently.

The economic concept of equity has been shown by economists, historically and currently in Chapter 3, to be a vital contributing factor towards tax reform policy globally. However, contemporary economists believe the economic concept of efficiency is equally important as the concept of equity due to the trade-off between equity and efficiency that affects tax policy either adversely or successfully. Due to this unexpected compromise, this study would be incomplete without addressing efficiency as a factor affecting both tax policy reform and equity challenges that may exist (Chapter 4).

A study of the concept of fairness is included aside from the concept of equity as this is a controversial concept with some studies using the terms equity and fairness interchangeably.

Equity is affected by underlying non-economic factors which have been mentioned in the text for purposes of completion.

Recent tax reform policies in transition and developing countries have been reviewed as these are considered 'third world countries' much like South Africa.

The inequality factor, or GINI index, is representative of a wealth distribution index which is often utilised when introducing tax reform measures as it is believed a progressive tax system reduces this inequality. As this study concentrates on income rather than wealth, vertical equity principles although briefly mentioned are not dealt with in detail.

## **1.5 Problem statement**

With reference to the above, this proposed research will address:

Equity within the present personal income tax system in South Africa, expand on issues that impact equity directly with the prospect of improving the present progressive system with a non-progressive system while evaluating current tax reform approaches in transition and developing countries in search of possible solutions.

## **1.6 Objectives**

The primary objective of this study would be:

- To assess equity issues inherent in the taxation of natural persons in South Africa and the possible implementation of alternate tax reform systems.

The primary objective would be enhanced by:

- A historical review of the economic principles and history of taxation as suggested by economists past and present (Chapter 3)
- Expansion of the economic principles focussing on equity with its resultant effects on the shadow economy and taxpayer perception. A study of efficiency is also included as modern economists believe there is a trade-off between equity and efficiency (Chapter 4)
- An analysis of the Income Tax Act 58 of 1962 with historic and current tax commission findings relating to the incentives and deductions for individual taxpayers to address the

advantages /disadvantages of the present tax system in South Africa and its resultant effect on equity, efficiency, fairness and the total revenue collected (Chapter 5)

- An investigation into alternative tax reform systems, their implementation and impact on equity and efficiency in the countries that have implemented these globally (Chapter 6)
- To suggest alternative tax reform methods relating to the personal income tax in South Africa based on the findings of the previous chapters (Chapter 7).

## **1.7 Research methodology**

Research into income tax and law principles fall into the category of social research, an area described as a “structured, organized and systematic process” used to produce knowledge (Neuman, 2003:2). Social research is underpinned by either quantitative qualities represented by a formal, objective and systematic process that is used to examine the cause and effect of variables being studied with the data being converted to numerical form and subject to statistical analyses (Babbie, 2004:396) or qualitative research which is represented by non-numerical observations and examination of data while maintaining a flexible approach (Kumar, 2011:34). Qualitative researchers rely on interpretive and critical social science techniques with quantitative researches relying on a positivist approach (Neuman, 2003:138). Qualitative researchers are further associated with applying an inductive approach to generating theory resulting in a more subjective perspective at constructing knowledge (Greener, 2008:17).

This analysis embraced a subsection of qualitative research which is usually adopted when legal systems are examined. Doctrinal research draws upon the particular legal system, in this study the Income Tax Act (No. 58 of 1962) to provide the necessary legal concepts, categories and criteria to enable reform to ensue (Hutchinson & Duncan, 2012:100). Tax research is multi-disciplinary and benefits from a comparative approach which provides a structure aimed at resolving a research problem (Buijze, 2016:190). Comparative tax research tends to be pragmatic and often descriptive with the challenge of political pressure and constantly evolving legislation providing further challenges (Ault & Arnold, 2004:2).

As this study overlaps the disciplines of tax and economics to facilitate an accomplished investigation into the current and possible reform procedures that could suffice, comparative tax issues are imperative albeit challenging due to the complexity of issue and its relatively fast changing nature. This qualitative interdisciplinary, archival study employs reform-oriented comparative doctrinal research which entails evaluating the existing laws and recommending any reform that may be apparent while comparing tax reform methods. The research principles referred to are expanded in Chapter Two.

## **1.8 Overview of chapters**

### **CHAPTER ONE: INTRODUCTION AND OVERVIEW**

The objective of this chapter was to formulate the problem statement and research objectives of this study by highlighting the present tax situation in South Africa and investigating other methods of taxation.

### **CHAPTER TWO: RESEARCH METHODOLOGY**

The research methods and methodology are discussed in detail with emphasis on the value of qualitative research. This study is predominantly an archival study leaning favourably towards literature of past and present economists and tax experts globally.

### **CHAPTER THREE: HISTORY OF ECONOMICS AND TAXATION**

This chapter emphasises the importance of historic economic principles and their relevance to present day taxation principles. Adam Smith formulated the four canons of taxation in 1776, principles which are considered significant when developing tax systems and introducing tax reform. However, economists from as early as 350 B. C. recognised the equity principles associated with an effective tax system. Later economists expanded on these theories and the relevance of these was considered in developing countries.

### **CHAPTER FOUR: EQUITY, EFFICIENCY AND FAIRNESS**

The historical importance of these concepts was established in the previous chapter and its importance personified. This chapter summarises the timeline and expands on the economic theory of equity, its association with the shadow economy and ultimately taxpayer perception. Taxpayer perception is important as this perception determines tax compliance in the country to a great degree. The Fischer tax model was used as a basic compliance instrument. Non-compliance ultimately results in inequities in an inequitable tax system.

### **CHAPTER FIVE: CURRENT TAX LEGISLATION IN SOUTH AFRICA**

This chapter assisted in gaining an understanding of the current tax position of individuals. Official tax statistics published by National Treasury and The South African Revenue Service compare the total amount of revenue collected from individuals as a percentage of the total revenue collected. Various commissions have been tasked with improving equity and fairness within the tax system and these reports have been examined.

## CHAPTER SIX: ALTERNATE TAX SYSTEMS

This chapter highlights alternative tax systems proposed and implemented globally. The successes, downfalls and ultimate results of these implementations were reviewed. Flat tax proposals, fair tax systems and dual tax systems were, among others, analysed.

## CHAPTER SEVEN: CONCLUSION

The importance of the various economic principles pertaining to tax legislation was reviewed and the issue of equity in the present day tax legislation addressed. Further suitable tax legislation was suggested although no empirical data was obtained limiting the discussion to unbiased tax systems without actually implying suitable tax rates.

### **1.9 Conclusion**

This chapter provided an overview of the qualitative, archival study with reform suggestions relating to the taxation of natural persons in South Africa presently.

The following chapter will expand on the research methodology and methods employed in this study followed by the historical significance of taxation in the field of economics.

## **CHAPTER TWO: RESEARCH METHODOLOGY**

### **2.1 Introduction**

The purpose of this chapter is to identify and expand on the research methods and methodology introduced in Section 1.6.

The term research has been defined by various authors with Kothari (2004:1) and Nayak and Singh (2015:1) defining it as “a scientific and systematic search for pertinent information on a specific topic” while Redman and Mory (1923:10) (cited in Kothari, 2004:1) defined research as “systematized effort to gain new knowledge”. Research can be further defined collectively as an academic activity that contributes to the existing body of knowledge through objective and systematic methods (Kothari, 2004:1).

Research involves the:

systematic, controlled, valid and rigorous exploration and description of what is not known and establishment of associations and causation that permit the accurate prediction of outcomes under a given set of conditions. (Kumar, 2011:92)

Almaki (2016:289) examined the various definitions and concluded research could be regarded as:

studious inquiry or examination investigation or experimentation aimed at the discovery and interpretation of facts, revision of accepted theories or laws in the light of new facts, or practical applications of such new or revised theories or laws.

The definition of research by Almaki (2016) represents the most favourable option for this study. The research process is further divided into methods and methodology which are discussed further.

### **2.2 Research methods and methodology**

Research methods can be described as the techniques used to conduct the research while research methodology is the science involved in solving the research problem (Greener, 2008:10; Kothari, 2004:7–8; Saunders *et al.*, 2009:3). Research methodology provides the philosophy, the values and the assumptions which steer the research and provide the basis for interpretation of results (Almaki, 2016:290).

Research methodology can be further defined as:

a research strategy that translates ontological and epistemological principles into guidelines that show how research is to be conducted and principles, procedures, and practices that govern research. (Nayak & Singh, 2015:1)

The ontological and epistemological principles associated with different kinds of research will be discussed later in Section 2.4.1 under Philosophical Assumptions.

The differences between methods and methodology can be summarized as follows in Table 2-1.

**Table 2 - 1: Research Methods versus Research Methodology**

<b>Research Methods</b>	<b>Research Methodology</b>
<ul style="list-style-type: none"><li>• Techniques for gathering evidence</li><li>• Various ways of proceeding in gathering information</li></ul>	<ul style="list-style-type: none"><li>• Underlying theory and analysis of how research does or should proceed, often influenced by discipline</li></ul>

(Nayak & Singh 2015:2)

### **2.3 Objectives of research**

While research procedures are improved through the refinement and extension of knowledge (Nayak, & Singh, 2015:4) the three main objectives of research are:

- Theoretical - which involves the formulation of new theories, principles or laws and is explanatory in nature,
- Factual - which entails the search for new facts and is descriptive in nature,
- Application - which suggests new applications, improvements and modifications in practice without contributing to the knowledge base but suggesting new applications for practical problems.

(Nayak & Singh, 2015:4)

However, Rajasekar *et al* (2013:2) further simplified the prime objectives of research :

- (1) to discover new facts
- (2) to verify and test important facts
- (3) to analyse an event or process or phenomenon to identify the cause and effect relationship
- (4) to develop new scientific tools, concepts and theories to solve and understand scientific and non-scientific problems
- (5) to find solutions to scientific, non-scientific and social problems and
- (6) to overcome or solve the problems occurring in our everyday life.

The application objective as suggested by Nayak and Singh (2015) with the need to overcome everyday problems pertaining to income tax would probably best describe this research. As every research is unique a general classification is never ideal but most appropriate. To achieve these objectives different research methods are employed as discussed further.

#### **2.4 Scientific research methods**

Science can be defined as “a systematic and organized body of knowledge in any area of inquiry that is acquired using a scientific method” (Neuman, 2003:10–11; Leedy & Ormrod, 2010:34; Nayak & Singh, 2015:6). Science is further divided into pure natural science and social sciences and as this research can be categorised as economically based research it will fall under social sciences. Social sciences can be defined as “the science of people or collections of people, such as groups, firms, societies, or economies, and their individual or collective behaviours” (Nayak & Singh, 2015:7) and can be referred to as “for, about and conducted by people” (Neuman, 2003:17).

Scientific research can be grouped into three categories (Nayak & Singh, 2015:7; Neuman, 2003:29; Rajasekar *et al*, 2013:10):

- Exploratory research where the goals of the research enable the researcher:
  1. to scope out the magnitude or extent of a particular phenomenon, problem, or behaviour,
  2. to generate some initial ideas (or “hunches”) about that phenomenon, or
  3. to test the feasibility of undertaking a more extensive study regarding that

phenomenon.

- Descriptive research which requires careful observations coupled with detailed documentation of the point of interest.
- Explanatory research seeks answers to the why and how types of problems, phenomena and behaviours.

This exploratory study initially identified the economic issue of equity as it relates to the Income Tax Act No. 58 of 1962 and investigated the various forms of equity with its related concepts. It further correlated the principles of equity to the current tax legislation in South Africa and investigated tax reform measures in transition and developing countries that may benefit the South African situation.

#### **2.4.1 Philosophical Assumptions**

Qualitative research dictates researchers make certain philosophical assumptions which consist of:

- Ontology depends on “beliefs about the nature of reality and humanity” (Nayak & Singh, 2015:1; Saunders *et al.*, 2009:110) being further divided into objectivism which portrays “the position that social entities exist in reality external to social actors concerned with their existence” (Saunders *et al.*, 2009:110) and subjectivism which dictates that “social phenomena are created from perception” (McKerchar, 2008:6; Ponterotto, 2005:130).
- Epistemology is the theory of the knowledge that informs the research (Creswell, 2007:17; Ponterotto, 2005:127).
- Methodology referring to how the knowledge is gained and constitutes acceptable knowledge in a particular field of study (Nayak & Singh, 2015:1; Saunders *et al.*, 2009:112).
- Axiology highlights the role of values in the research which entails that the inquirers actively report their values and biases as well as the value-laden nature of information gathered from the field (Creswell, 2007:16–18; Ponterotto, 2005:126).
- Rhetoric refers to the language of the research (Creswell, 2007:16–18; Ponterotto, 2005:126).

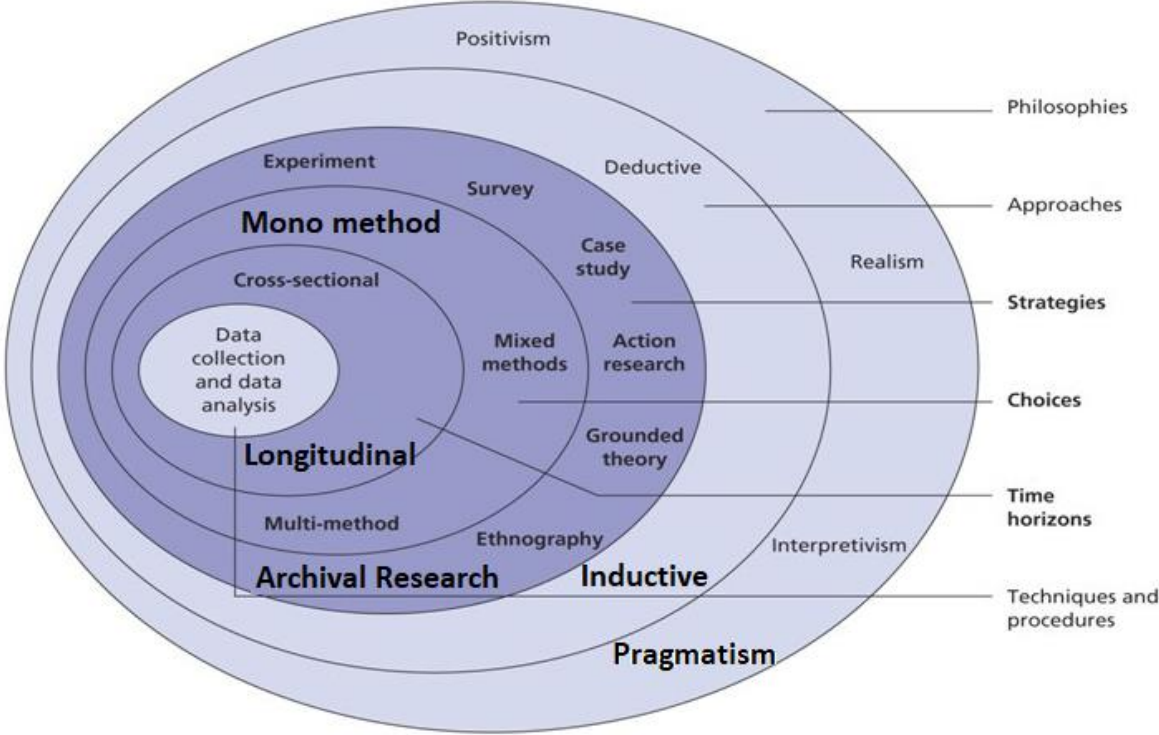
This study concentrates on the taxation of natural persons, a select group of taxpayers, and the rule of law which governs the taxation of individuals in South Africa. The theory that informed

this research will examine the present Income Tax Act (No. 58 of 1962) relating to natural person taxation and reform methods utilized in transition and developing countries to alleviate possible perceptions of inequity.

This research began with a question relating to equity which will be answered by the methodical gathering and analysis of data. The aim of this study is to provide an adequate knowledge for tax reform participants to draw on and to avail this logical baseline knowledge to future researchers. Income tax has a wide ranging effect on the lives of citizens in any country necessitating acceptable levels of understanding compelling the author to structure the language clearly and effectively to ensure an extensive audience.

**2.4.2 The Research Onion**

Saunders *et al.*(2009:108) equate research philosophies and approaches to the research onion shown in Figure 2-1. The research onion streamlines the assumptions, philosophies and approaches relating to the concept of research for ease of understanding.



**Figure 2 - 1 : The Research Onion**

(Saunders et al. 2009: 108)

The outer layer of the onion deals with philosophies or paradigms with Creswell (2007:19) referring to these philosophies or paradigms as “a basic set of beliefs that guide action”. These

paradigms or philosophies are divided into five major groups including positivism, post-positivism, constructivism or interpretivism, critical realism, and pragmatism which can be applied for academic research where:

- Positivism advocates working with an observable social reality that can be replicated (Ponterotto, 2005:128; Saunders *et al.*, 2009:598).
- Post positivism is the acceptance of an “objective reality that is only imperfectly apprehend able” (Creswell, 2007:20; Ponterotto, 2005:129).
- Constructivism or interpretivism “adheres to a relativist position that assumes multiple, apprehendable and equally valid realities” (Creswell, 2007:20–21; Ponterotto, 2005:129).
- Critical realism performs the function of disrupting and challenging the status quo (McKerchar, 2008:8; Ponterotto, 2005:129).
- Pragmatism argues that the most important determinant is the research question which could straddle over all the other philosophies (Creswell, 2007:23; McKerchar, 2008:8; Saunders *et al.*, 2009:109).

As a practical approach was required to ensure all data was collected and interpreted correctly, this study adopted the pragmatic philosophy which integrated different perspectives. Saunders *et al.*(2009:109) contend that research should not be limited but should traverse different ways which the researcher deems appropriate making pragmatism an appealing option.

Layer two recognises the approaches either inductive or deductive with the third layer recognising the strategy used. The building and testing of theories can be approached from two directions (Neuman, 2003:50) with the deductive approach beginning with an abstract, logical relationship proceeding towards tangible empirical evidence (Saunders *et al.*, 2009:489). The deductive approach is favoured when employing quantitative analyses. The inductive approach begins with detailed observations progressing towards more generalized conceptual ideas (Neuman, 2003:51) particularly favoured for qualitative design studies. Saunders *et al.* (2009:490) describe this approach as a grounded approach as data is collected initially in the exploratory phase, and analysed to develop the conceptual framework from which a theory emerges. As all data was secondary, extensive collection and analysis of the information necessitated an inductive approach which supported the eventual framework.

Layer three defines the strategies used with this research adopting predominantly the archival strategy as data collection depended on existing and archival documentation. However,

McKerchar (2008:18) commented on the lack of conceptual framework when performing legal research. As most of the material required is available, tax research which straddles both legal and social research patterns, an archival or historical study was implemented (Thuronyi, 2003).

The fourth layer recognises the choices made to complete the research which incorporates the method used which is either:

- mono method which denotes the use of a single data collection technique and analysis procedure,
- multi-method study which incorporates more than one data collection technique and analysis without straddling the methods i.e. the use of more than one quantitative collection technique and analysis,
- while mixed methods research utilizes both quantitative and qualitative techniques and analysis procedures depending on the researcher.

(Saunders *et al.*, 2009:595)

Data was collected and analysed using the mono method, a single, qualitative data collection technique.

Layer five represents the time horizons with a longitudinal study denoting the study of a particular incident over a long period of time and cross-sectional research referring to a phenomenon at a specific time (Saunders *et al.*, 2009:590–594) with the inner layer of the research onion concentrating on techniques and procedures used.

This study was undertaken over a period of time, not a specific event which classifies it as a longitudinal study.

To summarise: this study used the pragmatic philosophy, inductive approach, archival strategy and a single data collection technique to execute a qualitative research approach, further described in Section 2.5.

## **2.5 Research approaches**

Two broad streams of research approaches or methods exist, quantitative and qualitative. These streams can be used to reveal the intricacies of any given phenomenon (Kothari, 2004:5; Thomson, 2011:78). However, Almaki (2016:291) described the mixed methods approach as the third broad design of research. The similarities and differences between quantitative and qualitative data follows although this study necessitates additional approaches that need to be

discussed. This study straddles legal, tax and economic ideologies requiring subject specific approaches.

Quantitative research involves:

the generation of data in quantitative form which can be subjected to rigorous quantitative analysis in a formal and rigid fashion.

while qualitative research is concerned with:

subjective assessment of attitudes, opinions and behaviour. Research in such a situation is a function of researcher's insights and impressions.

(Kothari, 2004:5)

Quantitative research can be further defined as a formal, objective and systematic process that is used to examine the cause and effect among variables being studied with data being converted to numerical form and being subject to statistical analyses (Babbie, 2004:396). Qualitative research is, however, represented by non-numerical observations and examination of data while maintaining a flexible approach (Kumar, 2011:34) seeking to comprehend complex situations (Leedy & Ormrod, 2010:95).

Babbie (2004:26) differentiates between quantitative and qualitative data as the difference between numerical and non-numerical data. Quantitative data measures quality by numbers and "stresses the measurement of causal or correlational relationships between variables" (Ponterotto, 2005:126) whereas qualitative data is associated with "idiopathic explanations" (Babbie, 2004:27–28; Saunders *et al.*, 2009:151).

Qualitative research describes, explains, explores, interprets and builds theories (Leedy & Ormrod, 2010:96). Kumar (2011:92) further remarked:

As qualitative studies are characterised by an emphasis on describing, understanding and exploring phenomena using categorical and subjective measurement procedures, construction of hypotheses is neither advocated nor practised. In addition, as the degree of specificity needed to test a hypothesis is deliberately not adhered to in qualitative research, the testing of a hypothesis becomes difficult and meaningless.

Qualitative data tends to be inductive with the researcher identifying important patterns, relationships and categories in the data through a process of discovery with limited predefined measures and hypotheses (Nayak & Singh, 2015:143). Leedy and Ormrod (2010:96) proclaim

all research requires logical reasoning and is not exclusively inductive or deductive with both persuasions being employed in a continual cyclic fashion.

Doctrinal research, a sub-section of qualitative research, is derived from the Latin noun “doctrina” and means instruction, knowledge or learning. Doctrinal or theoretical research can be simply defined as “what the law is in a particular area” (Dobinson & Johns, 2007:19). This research is usually performed from a historical perspective and includes secondary sources of information (Dobinson & Johns, 2007:19). Doctrinal research can be coupled with problem, policy and law reform based research by determining the applicable legal aspect of the research problem, considering the flaws that exist and reinforcing the policy of the existing legal problem by highlighting the flaws (Dobinson & Johns, 2007:20).

Legal doctrinal research draws upon the legal system (in this study: The Income Tax Act No. 58 of 1962) to supply the concepts, categories and criteria. Doctrinal research is a two-part process of locating the law and then analysing the text which requires intense scholarly analysis (McKerchar, 2008:19). This method of research is underpinned by positivism and a view of the law being objective, neutral and fixed (Hutchinson & Duncan, 2012:110). Posner (1980:1114) highlighted the restrictions doctrinal research placed on the researcher who proposes to enter policy analysis and economic theory while addressing fundamental legal issues. Traditional doctrinal research is divided into economic analysis of law and a school of analysis where normative analysis trumps positive analysis (Posner, 1980:1115). Posner (1980:1119) further defined the different types of analyses as:

Positive analysis is the effort to understand phenomena, here legal phenomena, and normative analysis is the effort to prescribe and reform the law.

Other than legal analyses, tax classification of countries for the purpose of tax policy analysis can be examined along economic principles i.e. countries with higher incomes, transition countries and low-income or developing countries (Thuronyi, 2003:10). This comparative research allows for the “general, universal applicable legal principles” to be determined (Buijze, 2016:190) while establishing the number of areas where tax policy has converged (Thuronyi, 2003:15) or diverged.

The doctrinal study will be inspired by the relevant sections of the Income Tax Act No. 58 of 1962, that affect natural persons, where an analysis of the pertinent material and a review of historic and current Tax Commissions, based on the legal concepts, will be undertaken. To establish any reform suggestions, comparative research is vital where reform-orientated research is defined as that which “extensively evaluates the adequacy of existing rules and

recommends changes to any rules found wanting” (Hutchinson & Duncan, 2012:100) a view also held by McKerchar (2008:19). Dobinson and Johns (2007:20) further observed:

Problem, policy and law reform research often includes a consideration of the social factors involved and/or the social impact of current law and practice.

This qualitative study will employ reform oriented doctrinal comparative research which will evaluate the existing tax laws, and recommend any changes that may become apparent while analysing tax policy of various jurisdictions. The common features of tax policy internationally, irrespective of the jurisdictions or the legal background, relevant to this study is the adoption of income tax rates for individuals with many countries opting for a lowering of personal income tax rates (Thuronyi, 2003:15) to compete favourably on the international arena. Thuronyi (2003:15) also noted the difference in taxation rates for earned and unearned income becoming a popular tax reform policy.

This study is interdisciplinary traversing both legal and economic fields. Siems (2009:10) advanced the main aim of the theory related to law and economics as the understanding of the effect of legal concepts on overall social welfare which underlies this study with Thuronyi(2003:10) emphasising that the broad outlines of economic classification rests with tax revenues and the tax mix. Although Avi-Yonah *et al.*(2010:184) highlight four different comparative schools, functional, economic, cultural and critical, the economic approach appears most suitable for this study. The economic approach questions whether the present laws are efficient and suitable to that jurisdiction aimed at analysing the deviations from an economically efficient benchmark to promote distributional justice (Avi-Yonah *et al.*, 2010:184). However the author is aware that these schools of thought are methodological and ideological rallying points to launch the academic debate into a revised personal income tax system for South Africa.

## **2.6 Description of enquiry and broad research design**

Research design refers to a:

procedural plan that is adopted by the researcher to answer questions validly, objectively, accurately and economically. (Kumar, 2011:96)

The primary purpose of this exploratory, interpretive study was to assess the concepts of vertical and horizontal equity pertinent to the taxation of natural persons in the context of the Income Tax Act No.58 of 1962 of South Africa. The importance of the principle of equity was highlighted by examining the historical aspects of this concept both economically and in the light of religious sectors. The dominant religious texts were identified and any reference to tax or

equity principles established. This encouraged positive analysis to understand the principles of equity, its historical significance and its value in present day tax legislation.

On examination of these it was established that equity cannot be studied independently of other concepts that impact either adversely or favourably on this important concept. A study of the related concepts, economic and non-economic, was therefore included in the study of equity to provide a complete representation.

Legal research is often deductive as the general rules are available through the relevant legislation but the researcher examines the situation and draws conclusions from this (Hutchinson & Duncan, 2012:111). However, qualitative research is inductive with numerous authors attesting to the use of both deductive and inductive approaches (Leedy & Ormrod, 2010:96). Modern legal research, the denomination under which tax policy falls, uses a theoretical legal framework as a basis and highlights political, social and economic influences from outside the legal system (Vranken, 2010:114). A study of certain aspects of the Income Tax Act No.58 of 1962 (as amended) was performed to provide a basis for comparison with both internal and external influences.

The initial phase of locating the general rules in the Income Tax Act No.58 of 1962 can be described as traditional doctrinal research and has the following purpose:

- To satisfy the researcher's curiosity and need for better understanding of tax legislation,
- To test the feasibility of further research in the area,
- To develop methods for further studies.

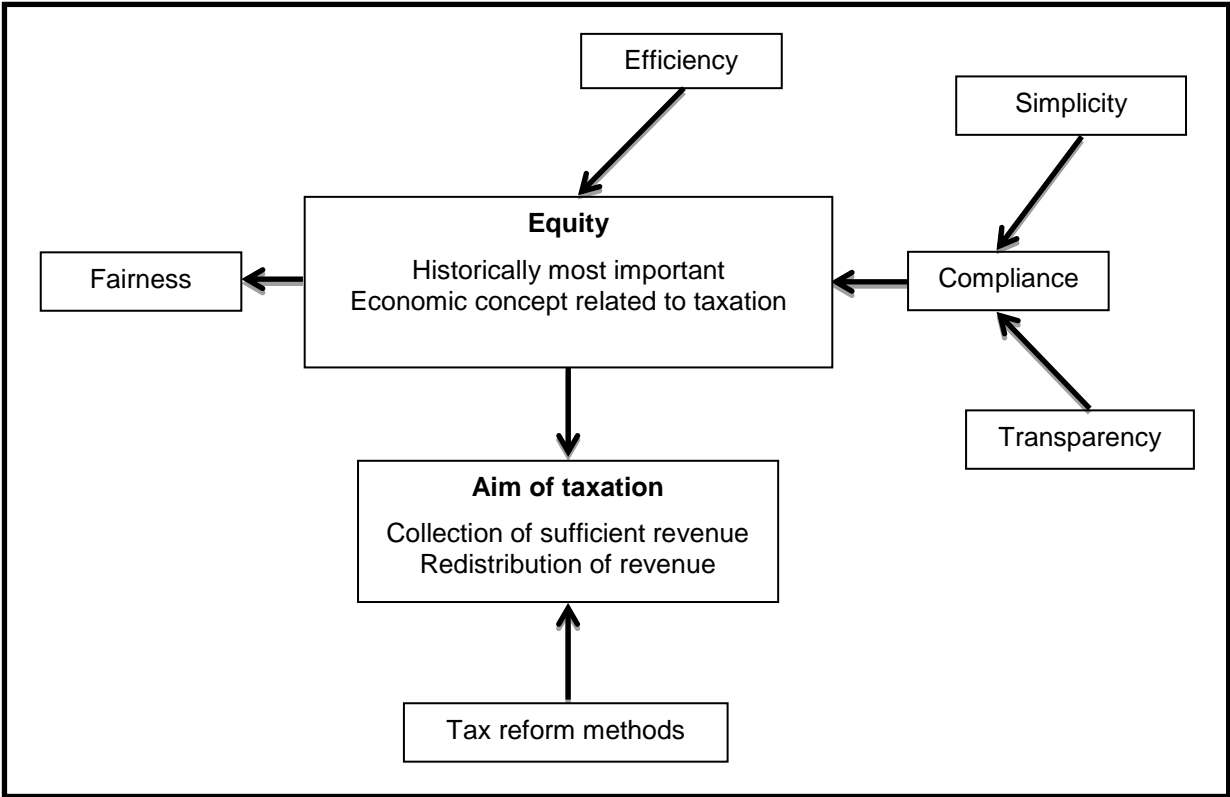
(Babbie, 2004:88)

Qualitative research involves the process of forming coherent theoretical concepts from the data collected by examining the nuances and complexities of a phenomenon (Leedy & Ormrod, 2010:94). The data are then linked to either create a theoretical relationship or not and may also be linked to other closely related ideas (Neuman, 2003:176). Although the concept of equity was the prominent variable the other accidental variables that were discovered impacted equity and ultimately tax compliance issues. Interpretation of qualitative data by the researcher takes the form of translation and eliciting a coherent thought process (Neuman, 2003:148) that captures the complexity of the fact (Leedy & Ormrod, 2010:97).

The associated comparative study of tax law, a complex continually revised concept, is often largely affected by politics as the legislation process requires political consent (Thuronyi,

2003:20) making this quite a subjective topic. The debate between the effectiveness of investment incentives and their effect on equity principles in tax reform countries was also analysed with the existing knowledge relating to revised income tax systems being reviewed in the context of developing and transition countries. Transition countries, as defined by Thuronyi (2003:33) include countries under transition to a market-related economy either from a socialist economy or post war. The Eastern Bloc countries that were analysed in this study were predominantly socialist economies that transgressed to capitalistic principles.

A study of developing countries was important as South Africa remains a developing nation within the structure of Sub Saharan Africa. Two tax regimes in the region were assessed for comparative purposes from the Southern African Development Block of countries as these are South Africa’s closest neighbours with favourable tax systems. Thuronyi (2003:25) divided countries according to their legal definitions with South Africa belonging to the common law family of the Commonwealth or a derivative of Roman-Dutch Law. Although each Commonwealth country has modified its tax laws, many still abide by the basic British imperial law standards (Thuronyi, 2003:26) or a derivative of it. Botswana and Mauritius, although French was based on the colonial system (Thuronyi, 2003:53) proved comparable countries as they both belonged to the colonial regime but have departed from their original tax laws.



**Figure 2 - 2 :** Framework underpinning this study relating to personal income tax  
(Source: Author)

This study concentrated on the personal income tax system in South Africa, the ultimate aim of which is to be used as a fundamental tool by decision makers keen to direct the use of scarce resources for public consumption in a democracy, while it performs an essential function in the economic cycle which must moreover be effective in its collection mechanism (Carnahan, 2015:169; Tanzi & Zee, 2000:299).

Historically, as has been established in Chapter Three, the economic concept of equity has been verified as the perpetual driver of a reliable, functioning tax system. With tax policy being a balancing act between equity and other related economic factors (Bird, 2003:4), this study sought to include the related factors in Chapter Four. Tax policy decisions, however, also need to incorporate administrative and political ideals embracing international norms and domestic factors (Bird, 2003:4; Tanzi & Zee, 2000:299) which were examined in Chapter Five where the present South African Tax System relating to personal income tax was explored considering the revenue collected from natural persons in relation to total revenue.

With tax experts and economists agreeing that the most important goals of levying tax involve the collection of sufficient revenue in an equitable and efficient manner (Gray, 1989:2), a study of alternate tax systems was performed in Chapter Six with emphasis being placed on transition and developing countries. Although an optimal tax system would ideally be the ultimate goal of lawmakers, the equity versus efficiency dilemma will always be present (Auerbach & Hassett, 2005:2–3). Difference in opinions about various tax reforms often emerge relating to the appropriate weighting to be placed on equity and efficiency, with possible differences of opinion between tax experts, economists and policymakers. Two issues dominate this argument: the progressive tax proponents believe that marginal tax rates should be progressive while the detractors believe the equity benefits from significantly graduated tax rates do not justify the costs in efficiency (Auerbach & Hassett, 2005:2–3) resulting in a comparative study of tax principles particularly among South Africa's closest neighbours, one with a proportional tax system and the other with a progressive tax system

This study further explores a possible conceptual model, using the findings of the exploratory research combined with the critical review of the literature available, for a revised personal income tax system in South Africa.

## **2.7 Data collection**

The collection of data can take the form of themes, motifs, generalizations and taxonomies (Neuman, 2003:145). Data was obtained from scholarly journals and historical texts.

The collection of data involved:

- A literature review to provide the knowledge base regarding revised tax systems. It includes a study of the historic intention of taxation to the present revised tax systems.
- Obtain the National Statistics of South Africa as published by the National Treasury and the South African Revenue Service until 2018 year of assessment.
- A study of the Income Tax Act No.58 of 1962 of South Africa and related academic texts.
- A study of alternate tax systems with the focus on single, non-progressive personal tax rates.

## **2.8 Quality and Rigour of the Research Design**

The conceptualisation of the operational plan was accomplished by ensuring accuracy, validity and reliability of data. Study designs related to qualitative methods are appropriate for exploring variation and diversity and are considered quite flexible (Kumar, 2011:104).

Qualitative research relies heavily on secondary data sources which present their own unique problems when considering the quality.

### **2.8.1 Reliability and Validity**

Data quality is measured in relation to the following aspects (Saunders *et al.*, 2009:326):

- Reliability refers to the extent to which the data collection techniques will produce consistent findings, observations and conclusions (Saunders *et al.*, 2009:600). Although qualitative researchers strive to be consistent their study processes may not be stable over time (Neuman, 2003:184). Qualitative studies rely on good quality rather than reliability with the purpose of generating understanding (Golafshani, 2003:601) and frequently use the term dependability rather than reliability.
- Validity – Qualitative research tends to lean towards authenticity rather than validity.

Validity is defined as being truthful while authenticity refers to a fair, balanced and honest method of capturing an inside view of the study data (Neuman, 2003:185). Leedy and Ormrod (2010:100) indicate the various terms suggested by researchers pertaining to validity in qualitative studies: “credibility, trustworthiness, confirmability, verification and transferability” (Golafshani, 2003:602). Validity, by whichever term it is referred to, ensures the application of correct procedures to obtain answers to the research question (Kumar, 2011:26; Saunders *et al.*, 2009:603) with accuracy, meaningfulness and credibility (Leedy & Ormrod, 2010:97).

The concepts of validity and reliability were further examined by Kumar (2011:172) who conceded:

In qualitative research, as answers to research questions are explored through multiple methods and procedures which are both flexible and evolving, to ensure standardisation of research tools as well as the processes becomes difficult.

There are, however, many versions of what constitutes reliable, valid data when considering qualitative research. Although reliability and validity are complementary concepts they may very rarely contradict each other (Neuman, 2003:186).

With the divergent views on valid and reliable qualitative research being argued at length, Kumar (2011:104) concluded, after comparing previous researchers' evidence, the four most relevant attributes of qualitative research are:

- Credibility
- Transferability
- Dependability
- Confirmability

While analysing sections of the current income tax legislation of South Africa (Income Tax Act 58 of 1962) that pertain to natural persons, coupled with an investigation of predominantly peer reviewed articles and texts, credibility and dependability were ensured. Numerous peer-reviewed academic articles and texts related to alternate tax systems in predominantly transition and developing countries were consulted and referenced. With the subject matter being so fluid it was difficult to not utilise material that is current especially in present day South Africa. All references are provided to ensure data quality has been adhered to.

### **2.8.2 Literature Review**

This study focussed on the equity principles associated with tax systems of natural persons in South Africa and the impact of these on revenue collection. To this end, an extensive and appropriate literature survey was performed to ensure a sturdy theoretical framework. Historical data coupled with contemporary material was utilised to ensure a credible basic theoretical background that was comparative and confirmable. Equity principles from approximately 500 B.C. to modern day concepts were sourced along with income tax information pertaining to personal income tax systems both locally and in transition and developing economies. Tax

reform techniques were then considered to assess possible tax reform instruments that could ensure maximum utilisation of potential tax revenue options. The literature review enabled comparison and verification with distinguished scholars and experts in their field.

Leedy and Ormrod (2010:66) defined literature review as the description of theoretical perspectives and prior research findings related to the particular topic. They further elaborate on the benefits of a literature review as offering new ideas and perspectives, revealing additional data sources and assist with interpretation of data. The literature review additionally provides detailed and validated analyses of the merits and faults of the chosen topic (Saunders *et al.*, 2009:590).

## **2.9 Research ethics**

Research ethics is broadly defined as the code of conduct employed by the researcher as it applies to certain groups or professions (Babbie, 2004:62; Neuman, 2003:116). Saunders *et al.* (2009:184) describes research ethics as the methods used to:

- formulate and clarify the research topic;
- design the research;
- gain access, collect, process and store data;
- analyse the data; and
- write up the research findings in a moral and responsible way.

Babbie (2004:72) refers to ethical issues as being “important and ambiguous” with social researchers disagreeing on general principles and specifics pertaining to the research topic.

Ethical clearance was not required for this research as no human subjects were interviewed. However, care was taken to ensure the general ethical principles were adhered to.

## **2.10 Conclusion**

This chapter focused on the methods and methodology that underpin this research. A comprehensive study of the qualitative research designs and methodology was explored on which the following chapters were built.

A pragmatic philosophy, inductive approach, archival strategy and a single data collection technique was employed to execute a qualitative research approach. A conceptual model using

the findings of the exploratory research combined with the critical review of the literature available was developed for South Africa. The rapidly evolving tax legislation in South Africa may have compromised the validity and reliability of the data. However, every effort was made to ensure all relevant data was referenced to alleviate any intentional misrepresentation.

The following chapter focusses on the historical significance of equity, the basic concept of the research problem.

## **CHAPTER THREE: ECONOMICS AND TAXATION**

### **3.1 Introduction**

As this study proposes to investigate the equity principles of the current income tax system on individual taxpayers, it is essential to examine the economic effects of taxation with particular reference to the economic principles of equity and its related concepts. Prior to the exploration of equity and this study necessitates a consideration of the economic history of taxation, specifically equity principles, which will be examined in this chapter.

Economic history is considered important when formulating tax policy as it helps ensure past errors are not repeated as Schumpeter (1986:11) believed that fundamental errors committed in economic analysis were due to lack of historical experience. Economic historical evidence highlights the distinct relationship between the fiscal burden placed on citizens and their level of tolerance towards an autocratic and unaccountable government (Baskaran, 2013:2). It should be noted that an increase in taxation by autocratic rulers resulted in both the French Revolution and the American Rebellion (Baskaran, 2013:2), situations highlighting the importance of the study of relevant economic history relating to taxation principles.

Although economic principles forwarded by economists have proved significant, the imposition of a 'tax' by religious denominations have had major consequences on later economic policy decisions. A study of the different forms of taxation imposed by different religious denominations are included as economic history incorporates the periods before and after Christ.

This chapter firstly summarises the historical consequences of tax equity policy from its inception to the dawn of modern tax principles. This summary is pursued by an in-depth study of the historical principles relating to taxation ideologies consistent with secondary objective number one. The objective of this text is to examine the early pre-Smith tax principles, analyse the tax principles proposed by Adam Smith and place more recent economic ideologies in context. The rationale behind the introduction of the modern tax system provides a background to engage in debate the most appropriate system that is fair to all people in a particular country. This chapter provides an insight into the development of taxation principles from the earliest known taxes to the findings of modern day economists. The historical data is arranged from the earliest taxation findings by economists to the most recent developments.

### 3.2 Economic significance of taxation

Economic principles play a significant role in taxation policy in an environment where individuals are active in generating income to provide for their daily needs (Eisenberg, 1934:211). Taxation policy is of interest to politicians, lawyers, accountants and economists among others. However, unlike the politician and lawyer, the economist is concerned with the social policy of measure, taxation's probable utility and its equitable justice (Eisenberg, 1934:211). Together with economic aspects politics and taxation are intertwined in many respects. Democratic representative governments evolved due to the need by monarchs to raise further tax revenue compelling these monarchs to relinquish some of their authority in exchange for the ability to raise different taxes (Ross, 2002:3). The significance of the study of economics in relation to taxation systems can be assessed from the findings of Alfred Marshall.

Marshall (1997:1) described economics as the study of:

mankind in the ordinary business of life; [where] it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing

Marshall (1997:14) further expanded this definition to include the motives which affect, most powerfully and steadily, man's conduct in the ordinary business of life. Economists tend to watch the conduct of a total class of people, sometimes a whole population and with the assistance of statistics ascertain the demand and supply of the said people with reasonable accuracy (Laibson & List, 2015:385; Marshall, 1997:26). Beginning with these simple calculations, economists further analyse the causes which govern the local distribution of different industries, the terms on which people in distant places exchange their goods with one another and the ways in which fluctuations of credit will affect foreign trade (Marshall, 1997:26). This economic theory is further advanced to denote the shift in the burden of tax from those upon which it is levied to those for which it caters (Marshall, 1997:26).

Furthermore the tax system employed should be consistent with the political climate as a socialist tax system would be inappropriate for a free market economy (Bogetic & Hillman, 1989:33). Traditionally tax systems should aspire to maximize revenue collection for the State in a fair, simple, efficient and equitable method (Bird, 2013:5). However, depending on the political climate and economic era opinions may differ with teachings from various economic eras defined by economic philosophy which is the conceptual, methodological and ethical issues arising within the discipline economics and began with Aristotle (384 -322 BC).

Historically, general economic theory existed before Christ albeit rudimentary economic principles. Although a historical perspective of general economic theory is important, the relationship between historical economists and taxation is of vital importance to this study to highlight the relationship between equity and tax.

### **3.2.1 Economics, Religion and Taxation**

Although the implementation of taxation is largely political in the current era, modern economic theory of taxation introduced by the early economists is of great importance.

Early writings on tax were usually based on some religious script with the most widely recognised religious taxation principles being discussed further.

#### **3.2.1.1 Biblical Taxation**

Oden (1984:162) ethically evaluated taxation systems described in the Hebrew Bible (Old Testament) in ancient Israel. Various types of taxes were levied by different leaders during this period with Oden (1984:163) concentrating on the principles of equity and distributive justice. Elon (1975:663) defined taxation for the purposes of Jewish history studies as:

a compulsory payment, in currency or in specie, exacted by a public authority, for the purpose of satisfying the latter's own needs or those of the public, or part of the public

on which Oden based his research.

As ancient Israel did not discriminate between the king's revenue and those of the kingdom, the king saw it fit to appoint his servants to oversee the collection of the temple offerings resulting in no clear distinction between secular and religious offerings (Boling, 1975:663; Oden, 1984:163; *The Holy Bible*, 1971:299). Taxation systems, although primitive, proved to be quite harsh depending on the ruler at the time. The Hebrew Bible (Old Testament) does not give a full account of taxes collected during the reign of various kings although these kings were "large landowners who often increased their personal fortunes during their reigns" (Oden, 1984:166).

Miller (2012:1) noted that taxation was an important aspect of biblical Israel with taxes being levied on both residents and foreigners with taxation taking various forms:

- Forced labour or mas – a tax evident by its use of labour to fulfil the needs of the reigning monarch
- The royal taxation system involved both the splitting of ancient Israel into twelve administrative districts by King Solomon in 1 Kings 4 (*The Holy Bible*, 1971:300) with each

district providing supplies to the King's household for one month of the year and the capture of flocks and herds by David in 1 Samuel 30:20 (*The Holy Bible*, 1971:267–268)

- Emergency tribute levy – a tax raised during periods of crisis to enable the payment of a tribute to the enemy.
- Head/Poll tax – a tax paid to the temple by persons over the age of twenty with no mention of the frequency of the tax
- Sabbatical year, jubilee year and gleaning rights –“represent welfare taxation systems according to which landowners and slave-owners are required to give up income they might otherwise expect for the benefit of those classes otherwise without protection in ancient Israel”.
- First fruits and other offerings – offered to the priests in proportion to the “receipt of goods from the God of Israel”
- Tithes – generally known as a tax of ten percent on agricultural produce

(Miller, 2012:4–5; Oden, 1984:165–171).

Taxes seemed to have been based on a proportional system with no clarity on the notion of progressivity. However the following seems to confirm the existence of a proportional tax system where a tax imposed on the people of Israel by Moses in Exodus 30:11-16 (*The Holy Bible*, 1971:75) was half a shekel with Exodus 30:15 specifically stating:

The rich shall not give more, the poor shall not give less,...when you give the LORD'S offering to make atonement for yourself

Exodus 30:16 (*The Holy Bible*, 1971:75) expands on this ensuring that the moneys were used for the enhancement of religious principles.

Oden (1984:174) recognised that equity can be interpreted in various ways but recognised those who argued for strict equity required every member of the community to contribute the identical amount in taxes.

It was, however, recognized that taxes had to make provision for those who lived in the community to share in the wealth. If this criterion was not fulfilled the tax would be judged as inadequate (Oden, 1984:175). Bartlett (2013:1231) further highlighted the importance of

redistributive justice observing the redistribution of public funds should observe the principles of commonality (solidarity) and equality.

Evans (2006:49) believed the tithe is representative of a flat tax as the word means “one-tenth” which is invoked by various Judo—Christian teachings. Regardless of wealth, the tithe was a fixed ten percent flat tax that is referred to in both the Old and New Testaments (Evans, 2006:49).

The New Testament of the *Holy Bible* in Romans 13:7 reiterated the importance of paying taxes (1 Kings 4 and Luke 20 -25) with:

Pay all of them their dues, taxes to whom taxes are due, revenue to whom revenue is due, respect to whom respect is due, honour to whom honour is due.

Luke 25 (*The Holy Bible*, 1971:80) further emphasised this concept echoing the sentiment that whatever belongs to Caesar’s will be retained by him but the things that belong to God will be God’s when questioned on whether payment should be made to Caesar.

Both the Old and the New Testaments of the *Holy Bible* advocated the paying of taxes even though the methods may be inconsistent. It is apparent that proportional rather than progressive tax systems were preferable and considered equitable. The religious scripts linked to Judaism similarly dictate the method and distribution of taxes.

### **3.2.1.2 Judaism**

Due to the development and structure of Jewish law, religious obligations are bound by three main bases: the *Torah*, Rabbis and custom (Chodorow, 2006:277). The source of the obligation prescribed the depth of observation with any responsibility based on the Torah having the force of law which must be strictly observed (Chodorow, 2006:277).

The *Torah* imposed the obligation of three tithes for three reasons, the first to support the Levites (regarded as God’s special servants), the second to allow people to congregate in a place of God, later declared as Jerusalem, and thirdly to support the poor (Chodorow, 2006:278). The Jewish calendar is based on a 7-year cycle which prescribes the distribution of the offerings based on this (Chodorow, 2006:279).

Hart (n.d.:78–79) highlighted the taxes and tithes, with respective rates, contained in the *Torah*:

- *Terumah* was levied to support the priests who did not own property and devoted themselves to the communal good including running the Temple.

Terumah, was given, according to rabbinic mandate at a level of between a fortieth, fiftieth or sixtieth of total produce, depending on the generosity of the payer.

- *Ma'aser rishon*, a tenth taken after *terumah* was taken, was given to support the landless *Levi'im* in their service educating and serving the Jewish people.
- *Ma'aser sheini* is a share of produce that had to be eaten in the capital, Jerusalem, or sold and substituted with food bought in Jerusalem, to support its economy.
- *Ma'aser ani*, is a ten per cent tax that went exclusively to the poor. In addition to these flat taxes, the Torah also requires all citizens to pay the raise money for the Temple.

Chodorow (2006:280) acknowledged the vast difference between present day taxes and those prescribed by Judaism and noted:

tithing operates as an income based tax insofar as the amount of the tax is determined as a percentage of one's income.

He further conceded although tithing may be regarded as a simple income tax or an income based consumption tax, the tithe amounts to 10 percent of produce which had to be distributed to the poor as dictated by the *Torah* (Chodorow, 2006:304). This distribution corresponds to the present day redistributive principles of taxation and adheres to the principles of proportional taxation.

Judaism further decrees that aggressive tax planning is an unfair and unethical exploitation of the system which is considered "a villainy within the delineations of the Torah" according to Professor Glicksberg (cited in Harari *et al.*, 2013:17).

### **3.2.1.3 The Holy Quran**

The *Holy Quran* endorses *Zakat* as one of the five pillars of Islam which are basic obligatory acts by believers and considered the foundation of Muslim life (Lorenz, 2013:2). *Zakat* was the main system of taxation during the Prophet's (peace be upon him (PBUH)) reign although other forms of taxation such as *Kharaj*, *Jizyah*, *Ushr* and *Khums* existed (Dangkua, 2015:1; Dhar, 2013:1).

*Zakat* was compulsory during the reign of the Prophet (PBUH) but resulted in some controversy over it being labelled a tax by certain groups of Muslim scholars (Dangkua, 2015:1; Mossavar-Rahmani & Maleki, 2009:30) who believe it is a religious duty rather than a system of taxation with the funds being allocated to a specific person and cannot be spent by the State at its

discretion. However, Ahmad (slide 18) alleged Zakat is neither voluntary nor a donation and is a duty that is part of the religion. He further stressed:

Zakat which is the core of the Islamic Taxation System has three major Economic effects:

- (a) Distribution Effect,
- (b) Income Effect, and
- (c) Growth Effect. (Ahmad, slide 23).

With Mossavar-Rahmani and Maleki (2009:32) concluding Zakat, a wealth tax is considered:

an obligation on Muslims to pay 2.5 percent of their wealth to specify[sic] categories in society, when their annual wealth exceed the minimum level (nisab).

Jizyah was a poll tax on non-Muslims living in an Islamic state specifically by the Prophet (PBUH) but has since been eliminated (Aliyu *et al.*, 2016:145; Dangkoa, 2015:2). Kharaj and Ushr have no Quranic basis but are respectively a land tax levied on conquered land and a foreign trade tax (Dangkoa, 2015:2). These were introduced by the second Caliph Umar to fund Islamic State expenditure (Dangkoa, 2015:3). However, Aliyu *et al* believed kharaj was prescribed in the Quran with only Ushr having been imposed later.

Although Muslim scholars recognized Zakat as the main form of taxation, other taxes were permissible subject to strict Shariah laws (Dangkoa, 2015:3) as highlighted by Hussain (1993:947–948); Aliyu *et al.* (2016:141) and Ahmad:

1. A tax should only be levied after intensive consultation with fuqaha (or Grand Ayatollah) and Muslim expert in fiscal and economy matters
2. Any proposed tax instrument should not duplicate the rules or function of zakat, for example, a tax imposed to provide or subsidize basic necessities for poor people would duplicate zakat
3. Any proposed taxation should not contradict the basic principles of the zakat system, for example, no tax should be imposed on low-income people because of its progressive or regressive nature
4. A tax should never carry the same obligatory and permanent nature of zakat, means that a tax that was introduced to serve a particular purpose must be removed once the target is achieved

5. Taxation for non-Muslims must follow the framework of justice based on their role in the society and may call for equal treatment with Muslims

The *Holy Quran*, according to Mossavar-Rahmani and Maleki (2009:34), promoted justice and fairness with the intention of alleviating poverty, fulfilling its citizen's needs and enhancing income distribution. Just tax rates, according to Hussain (1993:949), provide incentives for work and investment and attract barakah (blessings and growth) from Allah.

Although the *Holy Quran* prescribes Zakat as an obligatory tax, Muslim economists believed other taxes are mandatory as zakat cannot meet the general revenue requirements of any State (Lorenz, 2013:8). Hussain (1993:948) highlighted the Shariah requirement of levying taxes at rates that can be easily borne by the taxpayer without them feeling overburdened. These principles adhere to the ability-to-pay and just tax practices. Although zakat is considered a religious principle certain economists believe it predates the Islamic era (Aliyu *et al.*, 2016:144).

#### **3.2.1.4 Indian Adaptations of Religious Philosophy**

Sinha (2005:288) articulated the sources of religious principles in Hinduism as the *Ramayana* and *Mahabharata* transcribed during the periods 400 BC to 400 AD. Unfortunately there are no specific economic references in either of these Hindu religious texts. A further source of Hindu religious belief, the *Manusmriti*, contains economic advice given to the kings pertaining to among other issues taxation (Sinha, 2005:288). The *Manusmriti* advocated that traders and artisans should pay 1/5<sup>th</sup> of their profits in silver and gold, while the agriculturists were to pay 1/6<sup>th</sup>, 1/8<sup>th</sup> and 1/10<sup>th</sup> of their produce depending upon their circumstances.

No other religious texts affecting taxation have been discovered although there are vast amounts of taxation literature from the Indian continent further discussed in Section 3.3.2.

The first known economic references to taxes date back to almost 1800 years before Christ discussed in Section 3.3.

### **3.3 The first known taxes**

The earliest known civilization was in Mesopotamia, which literally means "land between the rivers" an area now known as Iraq. Although this area was situated between the Tigris and Euphrates rivers, it proved difficult to farm on, a semi-arid region with virtually no rain for eight months of the year (Ellickson & Thorland, 1995:329; Headrick, 2009:17). However, notwithstanding the difficulties faced by the landowners, the early governments demanded taxes in the form of statute labour referred to as the *corvée* which resulted in the control of large quantities of land (Forbes, 1965:5–6).

A decentralized system of administration of these payments was first noted during the reign of Hammurabi, in Babylon from 1792 to 1750 BC (Burg, 2004:x). This allowed for the collection of taxes from all areas controlled by the ruler of the time. More elaborate legal systems with military and bureaucratic establishments were introduced by the Assyrians and Babylonian theocracies from about 2000 B.C. (Schumpeter, 1986:49). The corvée continued, in certain instances, into the modern era for citizens too poor to pay other forms of taxes (Burg, 2004:viii). In addition a taille representing a tax on various forms of income and wealth particularly on land was imposed by the King in addition to the corvée (Chanel, 2015:68; Farhatullah, n.d.:5). In certain regions, the tithe, a collection of a percentage of the landowner's crops, was introduced (Burg, 2004:viii) which represented a tax paid to the church as a payment "in honour of God" (Farhatullah, n.d.:5). The peasants, who constituted most of the population, had to 'donate' a fixed proportion of their crops to the King (Chanel, 2015:69; Salanie, 2003:2). The tithe amounted to one-fifth of the produce in Egypt, one fifth of the produce of Palestine and a quarter of King Asoka's India (Pei, 1972:182).

Much later tax, farming and administrative tasks were converted to official posts "termed "liturgies" in which officials not only received little or no remuneration, but also were held responsible for the efficient fulfilment of their duties" (Burg, 2004:x). Citizens who performed this "liturgy" undertook to manage certain financial transactions on behalf of the community (Lyttkens, 2011:3) although any taxes that the financial officer was unable to recover from the taxpayer were extracted from the financial officer (Burg, 2004:x). This resulted in the collection methods being quite punitive with not only the taxpayer being held responsible for payment but also his family and neighbours (Burg, 2004:xi). These 'corrective' measures were, however, not consistent with the principles of redistribution of taxation. The collection of taxes was reasonably primitive without taking into account the principles of fairness and equity.

Taxation methods during these early years were oblivious to the needs and wants of the subjects of a State where a corvée, taille or a tithe was demanded, a method inconsistent with the later principles of fair, just and equitable taxation. Royal quests for additional tax revenues stimulated early advances in the documentation of recording systems where evidence supports the notion that tax revenue from the imposition of general taxes was employed to finance various royal services (Ellickson & Thorland, 1995:374–375). Clearly, the principles of equity and fairness were not considered when the peasants and landowners were required to pay part of their produce in the form of taxation. However unfair the practice this continued through to at least the fourteenth century AD (Salanie, 2003:3).

### 3.3.1 Ancient Greeks and Romans

The ancient Greeks were responsible for the introduction of a fairly complex system of taxation, the first mention of which is in 428 B.C. (Pei, 1972:183). The ancient Greek philosophers were political philosophers looking at economic theory from a political standpoint (Schumpeter, 1986:51). The resultant Greek tax bore a likeness to modern day income tax and was imposed on both residents and non-residents (Pei, 1972:183). Roman economists were influenced by the ancient Greek scholars who helped economists like Cicero and Seneca shape more modern economic thought (Schumpeter, 1986:62).

The Romans systemized taxation over a seven-hundred year period (Pei, 1972:183). The Romans advanced taxation theory to include the taxation of various forms of income and wealth. Among the types of Roman taxation the first known form was also the tithe, which was levied at a rate of a tenth of the produce of the land; if it was paid in cash as opposed to produce which was then referred to as a stipend (Pei, 1972:184). Monetary taxes, in addition to labour taxes, took the form of indirect taxes which were paid on transactions and goods or direct taxes paid on wealth and income (Salanie, 2003:2). Taxes were paid by scripture which was a rental paid on state property; a sales tax on the sale of slaves and auctions and an inheritance tax on any estate worth over a certain value (Pei, 1972:185). Occasionally when these taxes proved insufficient, additional taxes were introduced making the taxation system more complex (Pei, 1972:185; Smith, 2014:19). Although this system of taxation fell away with the invasion by the barbarians, many of the tax terms were retained which laid the foundation for the new feudal system of taxation (Pei, 1972:185).

Feudal lords exerted their authority by imposing taxes on their subjects to support and enhance their lifestyles irrespective of the hardship suffered by the subjects. The feudal system imposed the principle that all citizens irrespective of title must provide either military service or labour in return for the right to work the land (Salanie, 2003:2). This system did not encourage fair, equitable and just taxation as it was forced onto all subjects eventually resulting in its downfall. From the thirteenth century, capitalistic enterprise surfaced and attacked the feudal system from which a distinct economic pattern evolved (Schumpeter, 1986:74–75).

Although comparatively primitive, renowned scholars researched tax principles and its effects on the population. During the Fourth century B.C. great strides were made by an Indian economist, philosopher and advisor to the Royal Court relating to taxation principles.

### 3.3.2 Kautilya (371 B.C. – 283 B.C.)

A Fourth century B.C. Indian teacher, philosopher, economist and advisor to the royal court of Chandragupta Maurya wrote the *Arthashastra*, translated as the “science of wealth” as a guide for good governance by the then ruler. It is believed the teachings and works of Kautilya’s *Arthashastra* is the missing link between ancient and modern economics. Unfortunately, the *Arthashastra* was believed to have been lost during the Gupta era (319 to 590 AD) and only rediscovered at the beginning of the twentieth century (Waldauer *et al.*,1996).

Kautilya did not distinguish between the wealth of the monarch and the wealth of the subjects but ultimately believed in the benefit to the masses rather than to the king (Tanwar, 2014:33). Unlike the physiocrats, Kautilya believed in diversified economic growth which included the development of industry and commerce as well as agriculture to secure wealth (Darnal, n.d.:4; Skare, 2013:7). Economic growth to Kautilya, was a multi-dimensional phenomenon resulting in economic activity with the ultimate goal being increased productivity (Skare, 2013:6). Early Indian literature emphasises the role of the king as protector of his subjects, maintainer of peace and justice and the provider of economic assistance which resulted in a ‘dharmic’ social contract where the subjects were expected to pay taxes to the king (Darnal, n.d.:5–9). However, Kautilya proposed several underlying principles related to taxation of the King’s subjects. Ancient Indian tax theory was based on humanitarian considerations as well as universally accepted sound taxation principles (Sharma, 2013:45).

The *Arthashastra* identified the negative externalities associated with tax policies represented by higher taxes which led to lower consumption, lower personal incentives and lower production (Skare, 2013:14). These negative externalities ultimately resulted in higher unemployment and an inefficient economic cycle (Skare, 2013:14). Kautilya’s economic model encouraged economic growth through efficient monetary and fiscal policies and limited State expenditure. Treasury and revenue surpluses affect aggregate demand, stability of prices and ultimately economic growth. Kautilya’s economic model highlights the significance of State policy related to taxation revenue and expenditure and the resultant effects on the economy as a whole emphasising the importance of balance to maintain economic growth.

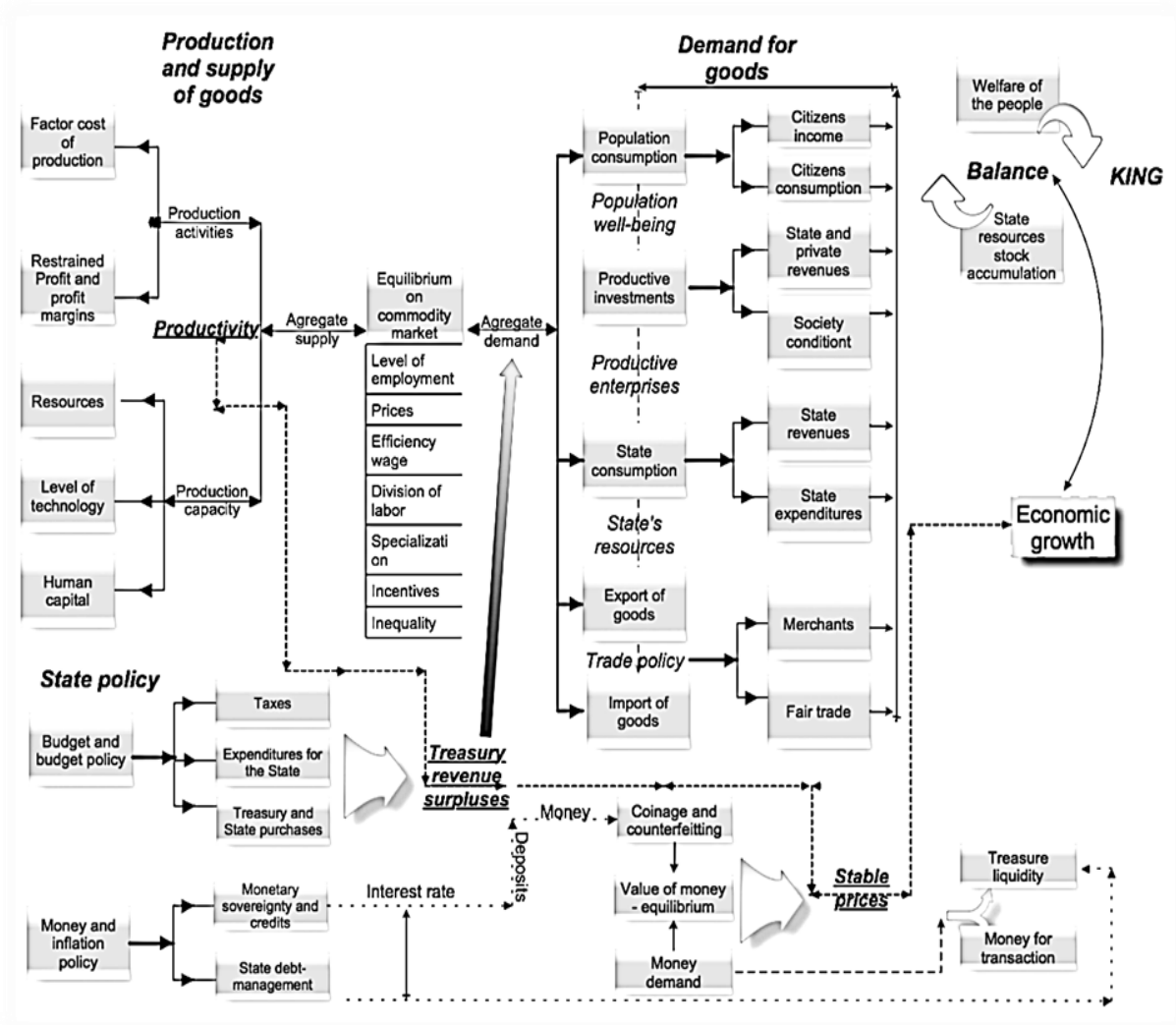


Figure 3 - 1: Kautilya's Economic Model.

Source: Skare, Marinko (2013:5)

The hallmark of the Kautilyan tax system was certainty of time, rate and mode of payment and stability (Darnal, n.d.:9). Kautilya criticised the excessive burden of tax on the populace and believed in increasing the tax base rather than the tax rate (Tanwar, 2014:34). Kautilya advocated the principle:

King must collect taxes like honey bee, enough to sustain but not too much to destroy (Tanwar, 2014:34)

Bhatt (2013:45) interpreted this as levying a bare minimum level of tax to eliminate any possibility of tax evasion while collecting the maximum amount of tax.

Tax collectors were required to be honest and humble towards taxpayers with the resultant wealth being able to facilitate orderly and peaceful administration of the State (Pandey, 2013:164). The underlying principles of the Kautilyan tax system highlighted the limitation of the taxing power of the State, the belief that taxes were not excessive and increases administered

gradually. During the Kautilyan era a linear tax system emphasising fairness, stability of tax structure, avoidance of crippling taxation and ensuring tax compliance with subsidies to encourage capital formation was suggested (Bhatt, 2013:45; Tanwar, 2014:34).

Kautilya advised on the rate of taxes which he believed should be adequate without being excessive. The functional tax relationship discussed in the *Arthashastra* between the rate of income tax and the magnitude of tax revenue is portrayed as the present-day Laffer curve (Tanwar, 2014:34). The Kautilyan/Laffer curve depicts the relationship between tax rates and total revenue collected. It is believed after a certain maximum point total revenue will decrease rather than increase as this point represents the limiting point between tax rates and tax revenue collection. The Laffer curve will be discussed later in Chapter 6, Section 6.3.1.

### **3.3.3 Western Civilizations**

The taxation systems of Western civilizations were not as advanced as Indian taxation systems during these early eras. By the time of the Norman conquest of England, a rather organised tax system had been established in France compared to England (Pei, 1972:185). Various forms of ordinary and extraordinary taxes or “taille” existed in ancient France although tax exemptions were extended to the King and religious organisations (Hoffman, 1986:43; Pei, 1972:186).

Early English tax systems, duplicated the features of the French model with the French “taille” becoming the tall age in Normandized England (Pei, 1972:187). Tax exemptions existed since the Anglo-Saxon times when the Council of Clovesho in 747 B.C. decreed the Crown powerless to tax religious bodies (Pei, 1972:187). This exemption from payment extended to nobility and expanded to many other countries exempting high priests in Egypt and Brahmin priests in Mauryan India (Burg, 2004:ix).

The first written form of taxation appeared in 1215 in the form of two chapters in the Magna Carta, a precursor to modern day taxation. Issues dealing with taxation in its most rural form were discussed in Chapters 12 and 14 of the Magna Carta (Helmholz, 1999:322). Chapters 12 and 14 taken together addressed the surrender of all powers of arbitrary taxation and the pronouncement of a nation’s right to tax itself (Helmholz, 1999:325). The idea of taxation, as opposed to specific tall ages described in the Encyclopaedia Britannica as “a tax imposed by the lord of an estate upon his unfree tenants”, and extractions, is essentially modern. The doctrine in 1215 did not refer to a regular scheme of taxation in the modern sense but expected the King to live off the land “like any other landowning gentleman” with no regular scheme of taxation in place (OLL, 2015:23).

This early interest in modern taxation albeit rural and ever changing led to an appreciation of the subject by modern economists even though the basic principles of modern taxation were not addressed. These early, rural forms of taxation seemed to have initiated awareness by modern economists who sought to delve into the economic foundations of this concept.

### **3.3.4 Eastern Medieval Scholars**

Although Schumpeter failed to recognise a period of about 500 years in his *History of Economic Analysis* and resumed the analysis with St Thomas Aquinos (1225 – 1274), recent research has confirmed the existence of Arab-Islamic economists during this blank period (Gazanfar, 2000:857). These 500 years between 800 and 1200 AD can be referred to as the Golden Age of Arab and Islamic development although this was the era of the European Dark Ages (Ali & Thompson, 1999:33). These medieval scholars viewed economic matters by the rules of justice derived from Jewish, Christian and Islamic scriptures (Gazanfar, 2000:859) (See Section 3.2.1).

Taxation was one of the most important issues of early Islamic writings (Ali & Thompson, 1999:33). At least thirty economic scholars have been discovered during the period of the Great Gap but the scope of this work relates to the history of taxation and will discuss only those scholars who actively indulged in taxation related issues. The first documented scholars, Caliphs Umar (died 644 AD); Ali (died 661 AD) and Umar bin Abd Al-Aziz (died 720 AD) emphasised the need for taxes to be collected with justice and leniency without being beyond the ability of the people (Chapra, 2008:16). These early scholars recognised the principles of equity and fairness and advocated the ability-to-pay principle. Abu Yousuf and Ibn Khaldun further explored the principles of taxation and its effectiveness as it related to that period.

#### **3.3.4.1 Abu Yousuf (731 AD – 798 AD)**

An Arab-Islamic scholar, Yousuf, was born in 731 AD in Koofa (Iraq) during the reign of the Ummayyad dynasty (Siddiqi & Gazanfar, 2003:210). In 750 AD, the Abbasid dynasty took over with borders that stretched from China and Sindh in the East to the deserts of Libya in the West and from the river Sabaoon and Mount Kafakaz in the North to Yemen and central Africa in the South (Siddiqi & Gazanfar, 2003:210). This was a period of great economic prosperity and Yousuf debated the economic responsibilities held by the rulers of the time with special emphasis on agriculture and taxation (Gazanfar, 1991:10). He proposed the levying of a tax on agricultural produce rather than the levying of tax on the land which he believed was more equitable and conducive to larger revenue collections (Gazanfar, 1991:11).

In his academic work *Kitab al-Kharaj*, Yousuf examined the principles of fixed versus proportional tax rates, the price of grain and its supply, tax collection and administration and the

financing of rural developmental projects (Siddiqi & Gazanfar, 2003:213). As Yousuf believed the state possessed the power to promote social welfare and overall economic development and prosperity, he did not examine state revenue and expenditure from a narrow perspective (Siddiqi & Gazanfar, 2003:225). However, detailed aspects of tax administration were discussed with several guidelines being suggested which included, fair and low tax rates to encourage agricultural production and a standardised tax rate imposed by central government to avoid abuse by tax collectors (Gazanfar, 2003:233). It was also suggested that tax collection should be carried out conveniently and in a civilised manner avoiding the use of middlemen with adequate compensation for tax collectors (Gazanfar, 2003:233).

Yousuf examined the system of taxation in great detail choosing to tax income rather than capital. He also advocated a fair, just and equitable tax system based on the ability-to-pay principle. However, he did not explore the expenditure side of taxation which may have been short-sighted. Many years later, the renowned scholar Ibn Khaldun recognized the decline in the Arab/Islamic civilization and sought to reverse this.

#### **3.3.4.2 Ibn Khaldun (1332 – 1406)**

Ibn Khaldun was born in Tunis in 1332 into an influential Arab-Andalusian (Spanish) family where it was obligatory that he be well educated according to traditional Islamic teachings (Patriarca, 2010:177). Unfortunately with the Maranid Invasion of 1347 to 1349, a grave pestilence known as the Black Death reduced Tunis to a ghost town resulting in the loss of both Ibn Khaldun's parents (Patriarca, 2010:177). He moved around the Northern African regions and Spain eventually settling in Egypt where he died in 1406 (Chapra, 2008:11). Ibn Khaldun realised the Muslim civilization was in a period of decline and wished to reverse this decline (Chapra, 2008:11).

He published his magnum opus, the *Muqaddimah*, a seven volume history which was completed in November 1377 where he introduced the cause and effect relationship into the discussion of historical phenomena (Ali & Thompson, 1999:39; Chapra, 2008:11).

Unlike other authors he sought to demonstrate the link between economic, social and political events through careful review, examination and analysis which he used to examine the influence of social environment and behaviour on economic behaviour and activity (Beik & Arsyianti, 2006:3).

Among other economic principles, the *Muqaddimah* stressed the principles of taxation referring to the concepts of equity, neutrality, convenience and productivity (Chapra, 1999:27, , 2008:17).

Ibn Khaldun emphasised the cyclical effect of the material basis of social life (Gierer, 2001:96). He explained this effect with respect to taxation:

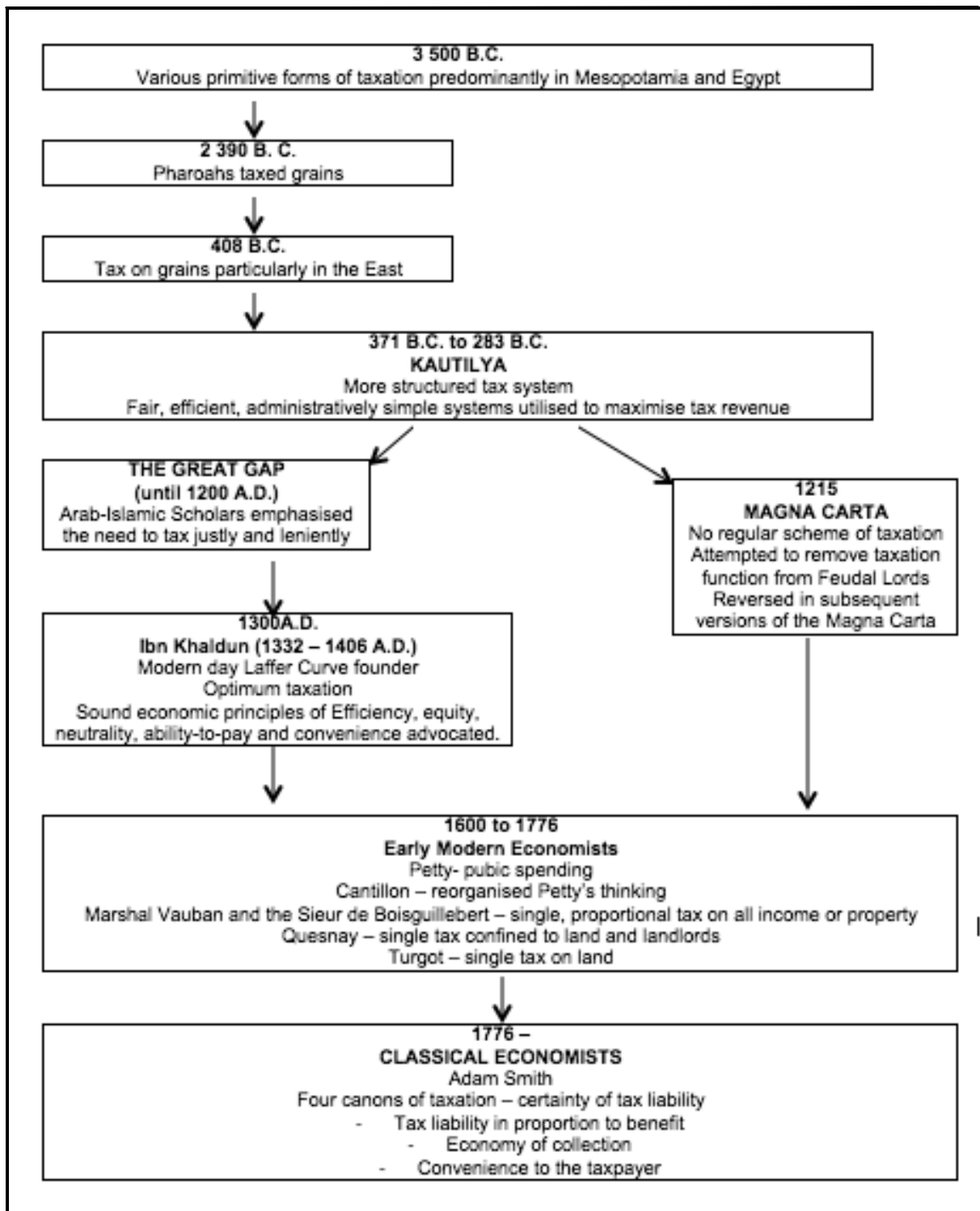
At the beginning of a dynasty, taxation yields large revenue from small assessments. At the end of the dynasty, taxation yields small revenue from large assessments ... As a result the individual imposts and assessments ...increase in order to obtain a higher tax revenue ...Eventually the taxes will weigh heavily upon subjects and overburden them ... The assessments increase beyond the limits of equity.

(Chapra, 1999:28; Gierer, 2001:96).

The notion of a higher tax rate not necessarily resulting in higher tax revenues was clearly understood by Ibn Khaldun (Islahi, 2006:16). He anticipated the gist of this effect in two chapters of the *Muqaddimah* (Chapra, 2008:17). Ibn Khaldun encountered that raising taxes would actually decrease tax revenue, a concept referred to as the Laffer curve in modern day economics (Ahmad, 2015:15; Chapra, 1999:27). Arthur Laffer later credited Ibn Khaldun as the original founder of the Laffer curve (Ahmad, 2015:15; McCaffrey, 2009:4).

Ibn Khaldun visualised the effect of incentives and productivity on taxation clearly leading the present generation to believe he understood the principles of optimum taxation (Chapra, 2008:17). He realized government expenditure was a major source of economic growth and analysed the revenue needed to support the population and ensure law, order and political stability (Islahi, 2006:8). Ibn Khaldun further demonstrated the multiplier effect of government spending and the effect the wealth of the subjects have on the wealth of the dynasty (Islahi, 2006:9). Ibn Khaldun emphasised the principles of equity, efficiency, neutrality, ability-to-pay, benefit and convenience needed to optimise tax revenues while encouraging sound tax principles (Islahi, 2006:17). He ultimately advocated for justice in taxation (Chapra, 2008:18).

A timeline demonstrating the major discoveries by economists from the era before Christ to the Classical findings of Adam Smith follows in Figure 3-2. The importance of equity is validated through the eras although most of these writings were not readily available to other economists.



**Figure 3 - 2: Historical sequence of economics of taxation**

(Source: Author)

### 3.4 Early modern / western economists

Early modern economists were most interested in whether or when taxes could be imposed, by whom and on whom, to what extent and for what purpose (Schumpeter, 1986:93; Smith,

1970:46). The fifteenth century rationale behind imposing taxes included payments for security and for services rendered by the government (Schumpeter, 1986:198; Smith, 1970:47). During the early eighteenth century, taxes were irrational and unwieldy resulting in a disorderly system of taxation (Schumpeter, 1986:197). From the beginning of the eighteenth century, the economists of the West analysed and commented on the economics of taxation resulting in more structured tax systems.

### **3.4.1 William Petty (1623 – 1687)**

Taxation in a more sophisticated form was introduced in the seventeenth century where Petty (Pressman, 2014:10; Schumpeter, 1986:204) was the first economist to emphasise the importance of public finance, government spending and tax policy on the economic well-being of a nation. Petty was a theorist who constructed analytical tools to work with numerical facts which resulted in a joint product of reasoning with numerical data (Schumpeter, 1986:204). Petty's primary concern related to how taxes were spent as he believed taxation hurt the economy only when tax revenues were removed from circulation (Musgrave, 1985:29; Pressman, 2014:10). He further recognised that taxation could have positive effects, if it encouraged consumption and high productivity goods, the national output could be increased (Pressman, 2014:10). Petty foreshadowed Keynes believing that some type of government expenditure needs to occur to eliminate idleness and create jobs (Musgrave, 1985:29; Pressman, 2014:10). Although Petty's economic thought was almost identical to other economists of the era, his concepts were more refined due to the statistical investigations he performed (Schumpeter, 1986:206).

Petty realised the need for maximum tax revenue collection although he concentrated on the expenditure aspect of taxation which he believed improved the overall tax system that he proposed. The progressive versus proportional tax debate probably originated with Petty. Petty's views were further enhanced by Cantillon.

### **3.4.2 Richard Cantillon (1687? – 1734?)**

The French writers, despite their diversity should be regarded as the forerunners of the individualistic, micro, deductive and subjective value approach that originated in the 1870's (Rothbard, 2006a:345). Although Adam Smith offered the most convenient point of departure for modern economic thought (Musgrave, 1985:2), Cantillon, according to Rothbard (2006b:346) is the father of modern economics who he described as a "gallicized Irish merchant, banker and adventurer who wrote the first treatise on economics more than four decades before the *Wealth of Nations*" was published. Cantillon, a successful banker and speculator wrote the *Essai sur la*

*Nature du Commerce en General* around 1730 but this text was only published in 1755 posthumously.

Cantillon was the first theorist to demarcate economics as an independent area of study separate from ethical and political concerns (Rothbard, 2006a:347). The essential economic ideas contained in the *Essai sur la Nature du Commerce en General*, were originally Petty's but Cantillon presented these in a well-rounded systematic form (Schumpeter, 1986:210). The *Essai sur la Nature du Commerce en General* was widely read and influential throughout the eighteenth century resulting in it being echoed by Scottish philosopher David Hume (Rothbard, 2006a:360). Cantillon believed tax revenues were more easily raised in a state where money is plentiful giving the State an advantage over adversaries where money was scarce (Cantillon, 1755:163). The Cantillon economic theory was highly influential among Continental and British economists until the publication of the *Wealth of Nations* in 1776 (Rothbard, 2006a:361). The *Essai sur la Nature du Commerce en General* is regarded as the first real economic treatise (Pressman, 2014:15).

Cantillon did not propose new tax principles; he merely organised and published those proposed by Petty in the form of a text. His economic principles though were widely held as the first structured economic policies.

### **3.4.3 Marshal Vauban (1633 – 1707) and Sieur de Boisguillebert (1646 – 1714)**

In the latter decades of the seventeenth and the early years of the eighteenth century, Vauban and the Boisguillebert proposed a single tax, a proportional tax on all income or property that would result in a “simple, direct, universal tax to replace the French monstrous and crippling network of taxation” (Rothbard, 2006a:371).

Boisguillebert, although chiefly occupied with problems related to French fiscal policy, differed from Vauban as the scope of his economic interests were wider and more theoretically based (Schumpeter, 1986:208). A distinct analytical link can be traced between Boisguillebert and Quesnay's views on money (Schumpeter, 1986:208).

Vauban is probably the first published contemporary economist who advocated a single rate tax although the principle of proportionality was apparent in earlier writings. Very little is known about this tax system except that these economists opted for simplicity and probably fairness. Their ideas were improved on by Francois Quesnay and the physiocrats who promoted a tax on capital rather than on income.

#### **3.4.4 Francois Quesnay (1694 – 1774)**

Quesnay a surgeon-physician, best known as the creator of the *Tableau Economique*, advanced the idea of taxes being placed on landlords and not on the agricultural or manufacturing sectors (Pressman, 2014:20). He reasoned landlords produced nothing and a tax on this group would not reduce inputs resulting in no subsequent economic decline making it the best form of taxation (Pressman, 2014:20; Schumpeter, 1986:223).

A single tax on land, “*l’impot unique*” as it was referred to, was proposed by Dr Quesnay and the physiocrats to solve the problem of taxation (Rothbard, 2006a:371; Schumpeter, 1986:222). They, however, believed the tax should be low, proportional and confined only to tax on land and on landlords (Rothbard, 2006a:372). Their rationale behind this decision being as land is productive it produces by creating matter, all other activities such as trade, commerce, manufacturing and services are sterile that is they transform matter without creating it (Musgrave, 1985:22; Rothbard, 2006a:372). This view was contrary to the Cantillon theory which recognised land and labour as original production factors and entrepreneurs as the motor of the market economy adjusting resources to the demand of consumers and the uncertainty of the market (Rothbard, 2006a:372). The physiocrats believed all activity except agriculture was unproductive leading Quesnay to denounce the restriction on investment and capital growth resulting from high interest rates (Rothbard, 2006a:373).

Redistribution of income, equity and efficiency were not priorities when Quesnay formulated his economic policies which laid the foundation for future economic assessments. It is contended that flawed economic theories were introduced at this stage which led to the digression in economic thinking. Quesnay’s theories were followed by Turgot, a French finance minister who aimed for practical rather than theoretical economic growth.

#### **3.4.5 Anne Robert Jacques Turgot (1727 – 1781)**

In 1763 Jacques Turgot the baron of de l’Aulne, worked out his *Plan for a Paper on Taxation in General* where he showed how taxation crippled commerce, urban taxes distorted the location of towns and led to the illegal evasion of duties (Rothbard, 2006a:389). Turgot emulated the physiocrats by advocating freedom of trade and calling for a single tax on land (Rothbard, 2006a:389). Turgot’s summation of the tax system was “it seems that Public Finance, like a greedy monster, has been lying in wait for the entire wealth of the people” (Rothbard, 2006a:389), a statement made before the French Revolution (1789 – 1799)..

The early tax beliefs until mid-eighteenth century varied vastly depending on the economists regard for taxable versus non-taxable commodities. Economic thought ranged from taxing only

land to analysing and implementing taxes on labour. In essence the debate during this century was whether tax should be levied on capital, income or both. Unlike earlier economic writings their focus differed from the earlier principles of equity, efficiency and simplicity. These pre-mid eighteenth century economists were followed by the era of the classical economists which actually began in 1776 with the publication of *Wealth of Nations* by Adam Smith.

### **3.5 Classical economists**

Although classical economists took a broader view of income than the physiocrats, taxation on wages and subsistence were frowned upon but implemented (Musgrave, 1985:22;30). As rents, profits and income remained eligible sources of taxation so did capital and manufacture, the third tax element introduced by Classical economists (Musgrave, 1985:30).

The first and probably the most famous of the classical economists was Smith who published what is now known as the four canons of taxation. Even though these have been analysed and evaluated through the centuries they are still regarded as the most important factors affecting tax policy. The important principles of equity and fairness are housed within these canons around which many economists have expanded economic taxation theory.

#### **3.5.1 Adam Smith (1723 – 1790)**

Although Rothbard (2006b:435), an Austrian economist, described Smith as being hailed as the Founding Father of economic thought, he conceded these ideas were collected from original sources that were never acknowledged (Sihag, 2016:59). According to Sihag (2016:59) there is consensus that the *Wealth of Nations* does not contain any ideas that qualify as original. Literature on economic history barely mentions the mercantilists and the physiocrats but invariably start with Smith as the creator of the discipline excusing any resultant errors in his theory as inevitable flaws of a great pioneer (Rothbard, 2006a:435).

Smith's tribute to Kautilya's Arthashastra is recognizable in the identification of land, labour and capital as important sources for economic growth (Sihag, 2016:60). Another important parallel theory relates to the four canons of taxation: certainty of tax liability, tax liability in proportion to benefit, economy of collection and convenience to the taxpayer, which were first noted in the Kautilya's Arthashastra (Sihag, 2016:60). The Arthashastra by Kautilya is examined in Section 3.3.2 of this chapter.

Pressman (2014:26) believed Smith is the father of economics not due to the originality of his ideas but his vision of capitalism as an economic system. Smith was the first economist to

recognise the benefits of reduced government involvement in the economy and recommended government actions to counter monopolistic tendencies and practices (Pressman, 2014:26).

Smith was either idolised or considered an impostor depending on the era and historical references made (Pressman, 2014:26; Rothbard, 2006b:435; Sihag, 2016:59). However, he synthesised the findings of earlier economists into four succinct principles which have been followed to present day economic taxation theory. Although the next section may seem repetitive it is important to complete the illustration and emphasise the importance of equity in tax policy with a brief overview of historic events and findings.

### **3.5.1.1 Canons of Taxation**

Smith (1991:498–499) divided tax principles into four canons also referred to maxims which have represent the foundation of tax policy:

1. The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.
2. The tax which each individual is bound to pay ought to be certain. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person.
3. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
4. Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.

An analysis of these four maxims is important to this study as these factors are relevant to present day taxation systems. Modern economic theory may have expanded on these maxims but their basic principles are still relevant.

### **3.5.1.2 Ability to Pay**

The first maxim, often referred to as the ‘ability to pay’ principle in modern day taxation, should ideally result in each person contributing an equal proportion of income towards tax, ensuring all persons in that State incur tax expenditure uniformly (Browning, 1978:649). This would result in a fair distribution of the tax burden and no person would feel prejudiced.

Further interpretation of Adam Smith's first maxim and the society in which he lived, revealed that he referred to the amount of tax levied on the rental value of land in an era where they were considered synonymous with the general investment in eighteenth century Britain being landed property (Lambert, 1992:4). It is argued when (Smith, 1991:498) proposed the first maxim:

in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State

he was advocating neither a proportional nor progressive tax system but rather an 'economic rent' payable on private property according to its annual value (Lambert, 1992:4). However, Pressman (2014:33) advocated proportional meant "everyone should pay about the same percentage of their income in taxes". At the time of Smith's writing, taxes were regressive taking a larger fraction from the income of poor families rather than from that of wealthy families (Pressman, 2014:33). Smith believed, according to Pressman (2014:33), a proportional tax would have reduced the tax burden on low income families and increased the tax burden on those families with larger incomes.

The ability to pay principle as envisaged by Adam Smith assumed there was no distinction between the ability to pay and the benefits received (Sandmo, 2014:12). According to the first maxim, an individual's income was both a measure of ability to pay taxes and the benefits received from government, resulting in an individual whose income was large receiving more benefits (Sandmo, 2014:12). However, later economists drew a distinction between taxation according to the ability to pay and the benefits received (Sandmo, 2014:12).

Rothbard (2006c:467) believed Smith advocated the 'soak-the-rich policy' of progressive taxation when he proposed this maxim. This is further substantiated in the Principles of Tax Policy (ACCA, 2010:3) where this first maxim is labelled as the most contentious seemingly to argue for a progressive tax system. Most modern tax systems do follow this principle of progressive taxation but it is arguably a political stance rather than a statement of fact (ACCA, 2010:3).

The debate relating to progressive versus proportional taxation is still hotly debated in economic and political circles particularly when tax reform principles are considered as the system employed impacts on equity principles. It is similarly necessary for a tax system to adhere to the principles of vertical and horizontal equity (Cordes, 1999:195). This maxim remains the most controversial of the four maxims as it is interpreted by some economists as implying the need for progressive taxation while others believe a proportional tax system was recommended.

### **3.5.1.3 Certainty**

The second maxim commonly referred to as the certainty principle develops assurances in respect of the amount of tax contributed to the State by taxpayers. Lambert (1992:3) compared this maxim to the capability of society understanding their basic rights under the constitution to the right of accepting the tax system of a country by every adult member of society. Should this be uncertain members of society will be unable to maximise their ability to conform. Lambert's view suggested members of a society should be certain of their need to pay taxes. However, Pressman (2014:33) believed Smith advanced the notion that tax laws should not be changed radically and annually as this would result in arbitrary rather than certain taxes. The general view relating to the maxim of certainty is that taxes should not be arbitrary as taxpayers require some semblance of certainty when paying taxes.

### **3.5.1.4 Convenience**

The third maxim of convenience refers to the levying of tax in a simple, understandable manner enabling all persons to succeed in paying tax in an uncomplicated, convenient manner. This simple maxim is universally ignored as most governments believe any inconsistency in payment is legitimised by its democratic status (Lambert, 1992:4). Politicians do not always prescribe to economic values and principles resulting in taxes being complicated, incomprehensible and difficult to execute (Pressman, 2014:34). Pressman (2014:33) compared this maxim to the current practice of taxing capital gains when they are realised and not on an annual basis while the asset is held.

### **3.5.1.5 Efficiency**

The fourth and last maxim deals with efficiency – the taxes levied must be efficient when compared to the cost of collection of such tax. Should the cost of collection be too high in relation to tax collected, the amount actually retained in the Government coffers would be too low (ACCA, 2017:21). Efficiency forms an important aspect of tax policy decisions and relate to the ensuing costs of taxation. Costs of taxation include administrative costs and tax reform strategies which if not adequately deliberated will result in an inefficient tax system (Bird, 2004b:135). The ultimate result will be inadequate revenue collection in the State coffers.

Most governments employ numerous assessors, inspectors, investigators and incur other tax related expenses (Lambert, 1992:4). Coupled with the expenses taxpayers incur to employ tax practitioners, accountants and other advisors due to the complexity of income tax legislation, the resultant income to the discus, net of administrative expenses, is far lower than the outlay by the taxpayer (Lambert, 1992:4). Although taxation should be designed not to damage economic

incentives or create excessive efforts to evade tax it should likewise not impose penalties that are harsh enough to ruin tax evaders (Pressman, 2014:34).

Tax reform policy plays a significant role when considering the fourth maxim. If the income tax legislation is unintelligible to most taxpayers, these taxpayers may choose to avoid and evade tax rather than employ professionals to administer their tax affairs (ACCA, 2017:6). This will result in lower revenue collection to the discus and ultimately an inefficient tax system as the tax base will be decreased. However, Sandmo (2014:12) analysed the fourth canon in a broader perspective and concluded the costs of taxation should incorporate the inefficiencies that arise in the private sector due to the adverse effects taxes have on production and on the incentive to save and invest.

### **3.5.1.6 Relevance of the Maxims/Canons**

A later economist, Colm (1934:319) referred to the canons of tax as mere guidelines to be followed when considering a tax system with the contents and relative emphasis placed on each of these canons dependent on historical and economic issues at the time. Pressman (2014:34) believed these principles of taxation were ultimately designed to generate growth affording the least amount of damage to economic growth. Smith's ultimate vision was of self and national interest in perfect harmony, resulting in economic growth and prosperity with the only potential problems being government intervention in the free market, monopolistic practices by businesses and bad tax policies (Pressman, 2014:33). Although this was an optimistic vision, serious and deep problems accompanied economic growth which Smith's successors were forced to address (Pressman, 2014:34).

### **3.5.2 Later Classical Economists**

Subsequently a number of economists either expanded on or deviated from the findings of Adam Smith. Schumpeter (1883 -1950), who studied the physiocrats and mercantilists, believed there was life and economics before Smith and sought to design fundamental paradigms of economics (Rothbard, 2006b:19).

#### **3.5.2.1 Jeremy Bendham (1748 – 1832)**

One of the first economists post the Smith era, Bendham was clearly heavily influenced by Smith's doctrines (Samuelson & Nordhaus, 1989:449). Bendham studied the principles necessary for compiling social legislation and introduced the notion of utility in economic analysis which provided a means for evaluating government policies and legislation (Pressman, 2014:35; Samuelson & Nordhaus, 1989:449). This made Bendham the forerunner of the

contemporary cost-benefit analysis where he proposed an evaluation by comparing the benefits of some expenditure with the costs produced by the “most vexatious and burdensome tax” (Pressman, 2014:38). He concluded if the costs from additional taxation were greater than the benefits of the public expenditure, the spending should not take place and the taxes should not be imposed (Pressman, 2014:38). Tax revenue is obtained from taxpayers to be utilised by governments for public expenditure programmes. An evaluation of tax reform suggestions ought to be performed prior to implementation to assess the cost-benefit analysis of the said tax reform (Bird, 2004b:149). This is an important concept as a negative cost-benefit analysis could result in decreased total revenue collected by governments.

Although the utilitarian principle has garnered supporters with some economists advancing this theory to what is now referred to as the optimal tax theory, the basic economic principles of equity and efficiency still need to be adhered to. Ricardo continued the capital tax versus revenue tax debate with no mention of the utilitarian phenomenon.

### **3.5.2.2 David Ricardo (1772 – 1823)**

Ricardo’s success was measured by his writings on monetary policy and free trade (Schumpeter, 1986:448). His interest in taxes resulted in the publication of *Principles of Political Economy and Taxation* in 1817, where he referred to taxes as “a portion of the produce of the land and labour of a country placed at the disposal of the government” (Ricardo, 1996:105). Taxes are always paid from either capital or revenue of the country where capital is separated into fixed or circulating depending on the durability of the capital (Ricardo, 1996:105). Ricardo (1996:106) believed growth in capital would have been greater had it not been for the levying of tax concluding whilst all taxes have a tendency to lessen the power to accumulate; all taxes fall on either capital or revenue. If taxes fall on capital they diminish the fund by which the productive industry of the country must be regulated, if they fall on revenue they lessen accumulation or force the contributors to save the amount of tax thereby reducing the amount spent on necessaries and luxuries of life (Ricardo, 1996:106). Taxation of profits led to undue meddling and capital flight which was detrimental to growth (Musgrave, 1985:22). Different forms of taxes will produce different consequences, with Ricardo (1996:106) stating:

...the great evil of taxation is to be found, not so much in any selection of its objects, as in the general amount of its effects taken collectively.

Pursuing this discussion of taxing capital and income, Ricardo (1996:107) concluded irrespective of whether taxes are laid on capital or on income, the ultimate payment of these is

made from income which results in diminished annual enjoyments of the people unless capital and income is proportionally increased.

Although Ricardo did not analyse equity and efficiency aspects of taxes he did recognise the possibility of tax affecting production and consumption depending on whether capital is taxed or revenue is taxed. Around the same period as Bentham and Ricardo, a French economist, Jean-Baptiste Say aired his controversial views on taxation.

### **3.5.2.3 Jean-Baptiste Say (1767 – 1832)**

A French economist, Say was influenced by the writings of Smith for the development of his economic thought (Plassart, 2009:237). He published *A Treatise on Political Economy* initially in 1803 and a later version in 1855. In an era when most economists did not regard taxation as an invasion of the rights of private property, Say's hostility towards taxation pervades his work with a clear-sighted view of the true nature of taxation (Rothbard, 2006b:40). Due to the controversial nature of Say's writings very little has been published about him or his writings.

Book III, Chapter VIII of *A Treatise of Political Economy* refers to taxation as:

the transfer of a portion of the national products from the hands of individuals to those of the government, for the purpose of meeting the public consumption or expenditure  
(Say, 1971:446).

Say (1971:446) believed whatever the form of taxation, it is a burden on the taxpayer and must be considered as a matter of fact and not as a right in the science of political economy. Say (1971:447) emphasised the objective of taxation was the value given by the taxpayer to the tax collector. Where the pressure of taxation urged the working classes to double production, resulting in an enlargement of the national production, Say (1971:446) retorted that effort cannot alone produce there must also be an injection of capital. It unfortunately followed that the accumulation of capital attracted further taxation on the subjects. This resulted in the subjects being taxed on both capital and revenue, a political venture that was far from ideal. Say (1971:446) also believed the values created by industry to quench the demands of taxation were not an increase in wealth as they were devoured by taxation. This proved unfair and inequitable to the subjects of the State. Brandly (2007:67) emphasised the fundamental struggle between taxpayers and tax consumers highlighted by Say who believed those who benefitted from tax were exploiting the taxpaying class creating a distinction between the tax payer and the tax gatherer.

Say (1971:450) resolved taxation, whether imposed on necessities or luxury goods, are harmful. Taxation on necessities has the effect of affecting both production and consumption while taxation on luxury goods extinguishes only a portion of the products on which it falls (Say, 1971:450). The reference to the costs of collection of taxes over the years are noted by Say (1971:452) where he stressed these could never be refunded in another form as both, the act of collecting by the nation and the act of paying by the individual, should in reality be measured as an act of value rather than of money. Say (1971:454) further cited

a tax merely proportionate to individual income would be far from equitable; and this is probably what Smith meant, by declaring it reasonable, that the rich man should contribute to the public expenses, not merely in proportion to the amount of his revenue, but even somewhat more. For my part, I have no hesitation in going further, and saying, that taxation cannot be equitable, unless its ratio is progressive.

Taxation is a necessary evil imposed by governments on their subjects. Brandy (2007:67–68) refers to Say as the Father of Austrian Public Finance and highlights his recognition of the coercive nature of taxation, it being involuntary and confiscatory. His conclusion highlights the accuracy of Say's demonstration relating to modern tax analysis: its effect on prices and output, an explanation of tax incidence, classification of costs over and above the tax burden, a basic understanding of what is now termed the Laffer curve and the ability to corrupt government officials. Taxation destroys capital, restricts the performance of a market economy and ultimately lowers the standard of living (Brandy, 2007:75–76). Laffer suggested that high tax rates reduce the tax base resulting in lower tax revenues due to lower economic activity (Samuelson & Nordhaus, 1989:210) similar to the findings of Say. Modern day economics termed this proposition the Laffer curve (Samuelson & Nordhaus, 1989:210). Say's policy recommendation was consistent with his views on tax:

The best scheme of [public] finance is, to spend as little as possible; and the best tax is always the lightest (Rothbard, 1994:89)

Although Say recognised the importance of levying taxes, he summed up its flaws and weaknesses perfectly. Say (1971:454) believed the levying of taxes should have an impartial effect on all classes taxing all taxpayers alike without being particularly burdensome to one class of taxpayer (Say, 1971:454). Say acknowledged the need for equity, efficiency and simplicity in a tax system. Say's findings were unfortunately met with disdain and very few economists acknowledged his discoveries.

### **3.5.3 Socialism and Communism**

Socialism can be traced to the second half of the eighteenth century with its beginnings during the French Revolution which lasted from 1789 to 1799 (Schumpeter, 1986:428). Socialism held the fundamental equality of all should involve a policy of public ownership, planning and redistribution that would result in parity of material conditions for all citizens (Mills, 1980:41) while communism advocated all assets should be owned by the Government (Marx & Engels, 2010:18). The terms socialism and communism are often used interchangeably with its rise being in direct contrast to market related and capitalist economies and their analyses by earlier economists (Marx & Engels, 2010).

According to Marx's theory, capitalism forced members of society into two groups: the working class (proletariat) and the capitalists (bourgeoisie) and marginalised any other groups that could potentially exist (Bolden *et al.*, 2003:3). This distinct segregation resulted in a state of alienation between members of society causing estrangement between these groups (Bolden *et al.*, 2003:4). The capitalists being in control of the government and power structures reinforced such economic conditions, a system despised by Marx. Socialists aspired towards equality of opportunity for self-realization, welfare and political influence with equality of social status (Roemer, 1995:20). Socialist principles did not sanction the growth of the economy and the increase in wealth of private entrepreneurs advocated by a free market economy.

#### **3.5.3.1 Karl Marx (1818 – 1883)**

Marx, a Prussian born philosopher, economist, sociologist, journalist and revolutionary socialist, is credited as the founder of the socialist movement (Pressman, 2014:62). Although Karl Marx is primarily associated with the study of socialism, he studied capitalistic economies and analysed their underlying problems (Pressman, 2014:62; Schumpeter, 1975:22). Together with Adam Smith and John Maynard Keynes, Karl Marx was regarded as one of the three giants in the history of economics (Pressman, 2014:69). However, unlike his contemporaries, Marx saw the dark-side of a capitalistic economy which he believed would be its ultimate demise (Pressman, 2014:69). In the *Manifesto of the Communist Party* (Marx & Engels, 2010:26), where the different classes comprising a population were defined, a number of measures were advanced to improve the economic status of the country, the second of which being a heavy or graduated income tax. Marx was the first economist to advocate a progressive tax system in contrast to earlier economists who advocated a proportional tax (Samuelson & Nordhaus, 1989:785). The *Manifesto of the Communist Party* proceeds to clarify the demise of the different classes using the measures advanced by this document and the ultimate demise of political power (Marx &

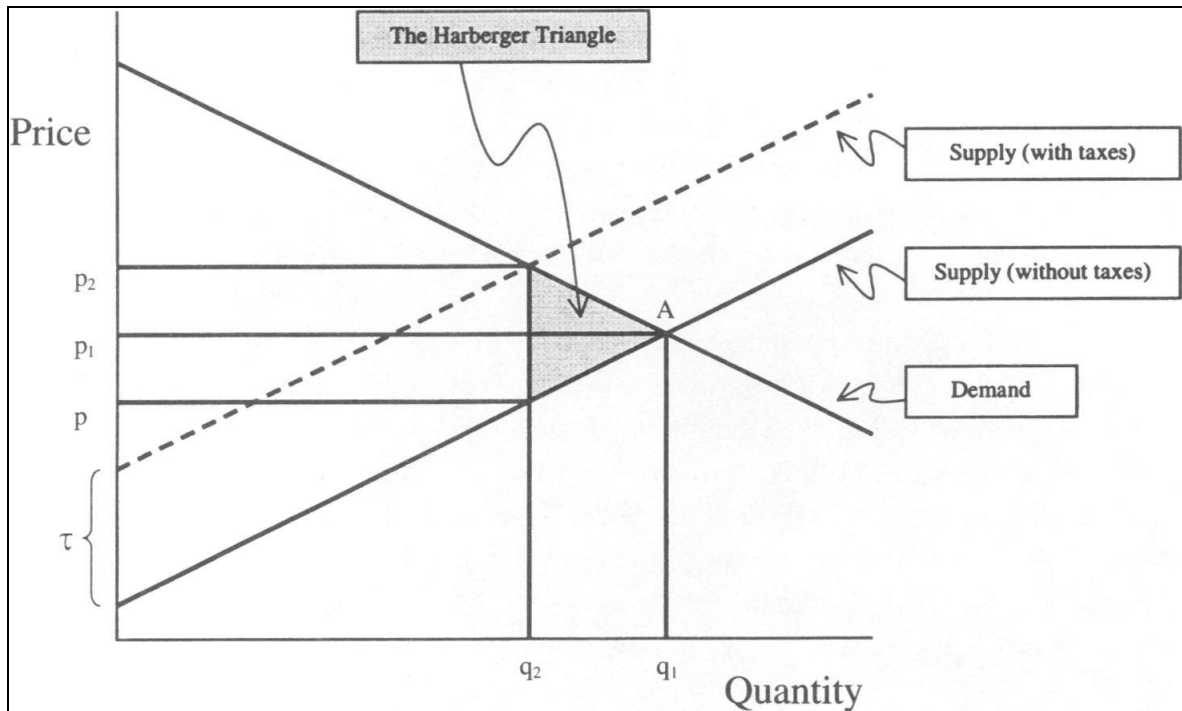
Engels, 2010:27). In later writings during May 1875, Marx further defined the word 'state' as a government machine that is separate from society.

Marx was instrumental in influencing the Russian leaders of the time to bypass capitalistic development and embrace socialism with the first taxes being introduced in 1918. He advocated for a progressive tax system (Marx & Engels, 2010:26), a method used presently by capitalistic societies. Taxes inevitably form the economic basis of the government machine, a concept which presupposes the various sources of income of the different social classes resulting in a capitalist society (McLellan, 2003:612). Marx predicted the fall of capitalism and the rise of socialism, but the opposite seems to have transpired.

### **3.6 Later Economic Contributions**

The concept of the supply and demand curve and its numerous applications can be traced to Karl Rau (1841), Jules Dupuit (1844), Hans von Mangoldt (1863) and Fleeming Jenkin (1870) (Humphrey, 1992:3). Of these economists, the most forward thinking was by far Jules Dupuit who derived welfare theorems from these curves. Although he assumed a constant supply price, from the demand curve he formulated the concepts of total utility, consumer surplus, deadweight-welfare-loss triangles and the Laffer curve relationship between tax rates and tax revenue (Hines, 2007:4; Humphrey, 1992:6). He demonstrated graphically (Figure 3-3 below) price changes induced by taxes reduced satisfaction by more than the generated revenue (Hines, 1999:169). With a constant supply curve Figure 3-3 establishes the theory of deadweight loss represented by the shaded triangle referred to as the Harberger triangle in the Figure below. The graph also depicts the decrease in demand representing a decrease in revenue from quantity 1 ( $q_1$ ) to quantity 2 ( $q_2$ ) by increasing the tax rate. An increase in price is consistent with a decrease in demand, in this instance the tax rate results in the deadweight loss. This triangle denotes the welfare lost to both the taxpayer and the State (Hines, 1999:169). Jenkin further refined Dupuit's welfare loss triangle which remains unchanged in present day economics (Hines, 1999:170). This concept remains vital to the study of efficiency of taxation as the area referred to as the deadweight loss represents the loss of efficiency.

The importance of efficiency has now extended to other areas of concern for example the influence of an increase in tax rates and its subsequent effects on total revenue collected (Hines, 1999:168). The deadweight loss theory is as applicable to current day taxation policies as it was when it was discovered.



**Figure 3 - 3: The Harberger Triangle.**

(Hines, 1999:169)

### 3.6.1 Marchese Vilfredo Pareto (1848 – 1923)

Pareto tried to broaden economic views by incorporating political and sociological variables to yield a comprehensive understanding of how real economics worked (Pressman, 2014:107). His general proposition shows that every indirect transfer of wealth from one individual to another is accompanied by a loss of wealth resulting in the government taxing some people for the benefit of others to modify the distribution of wealth (Pareto, 1897:499–500).

Pareto also contributed the notion of an optimal state of economic affairs, referred to as Pareto Optimality (Pressman, 2014:110). The notion of Pareto Optimality can be employed to evaluate proposed government policy changes (Pressman, 2014:110). This evaluation could determine whether the proposed government policy will receive public acceptance or not even before it is implemented. Pareto further analysed movements in the tax rate and its effect on total revenue and ultimately economic growth. Pareto submitted tax cuts for the wealthy could result in increased investment which could spur economic growth (Pressman, 2014:110). If lower income groups benefit as a result of greater growth, this tax policy could lead to a Pareto superior result (Pressman, 2014:111). However, if there is no income growth for lower income groups the current tax system could be seen to be Pareto Optimal and tax cuts for the wealthy would not be Pareto Superior (Pressman, 2014:111). An ideal tax system would be consistent with a Pareto optimal allocation of resources and can be said to be efficient (Sandmo, 1976:38).

### **3.6.2 Knut Wicksell (1851 – 1926)**

Wicksell made substantive contributions to the marginal productivity theory, monetary theory and to public finance. The second part of the theory of public finance involved taxation where Wicksell promoted the lowering of excise taxes and tariffs, developing a progressive income tax on individual and corporate incomes as well as increasing estate and inheritance taxes (Pressman, 2014:122). He believed earned income should be taxed at a lower rate than unearned income (Pressman, 2014:122). He advocated justice in taxation which he believed could be fulfilled by proportional representation of the population in the government (Wagner, 2002:35). The foundation for public choice theory was laid by Wicksell who tried to design an efficient, equitable tax system (Holcombe, 1998:361). Wicksell, a hard-headed realist criticized socialist ideas but promoted income redistribution and transfer benefits (Samuelson & Nordhaus, 1989:827).

Wicksell's theories can be seen as contradictory as he supported a capitalistic society while advocating a progressive tax system and state owned entities a theory promoted by Karl Marx (Marx & Engels, 2010:26) in keeping with socialist and communist principles.

### **3.6.3 Frank Ramsey (1903 – 1930)**

Ramsey, a British philosopher, mathematician and economist attempted to resolve the problem relating to the most efficient taxes (Samuelson & Nordhaus, 1989:668). The Ramsey tax rule was born which advocated the highest taxes should be levied on inputs and outputs that are price inelastic, that is, when a price increase of one percent triggers a less than one percent fall in quantity demanded (Lucas, 1990:299; Samuelson & Nordhaus, 1989:424;668). Ramsey's theory of efficiency encouraged later economists to develop the theory of optimal taxation.

### **3.6.4 Arthur Cecil Pigou (1877 – 1959)**

Pigou, a classical economist, argued in favour of government action to alleviate inequality, offset monopolistic distortions and remedy for externalities (Samuelson & Nordhaus, 1989:827). Pigou is known as the father of modern welfare economics which involves the study of efficiency and equity as well as the correlation between these two concepts (Pressman, 2014:134) (Pressman, 2014). He developed these devices to analyse the impact of taxes on the economy and the justification of government intervention in economic affairs (Pressman, 2014:134).

### **3.6.5 John Maynard Keynes (1883 – 1946)**

The Great Depression encouraged Keynes to publish a breakthrough in the *General theory of Employment, Interest and Money* in 1936 (Samuelson & Nordhaus, 1989:827). Keynes was the

pragmatist seeking the middle road compared to Adam Smith who was the optimist and Marx who was the pessimist (Pressman, 2014:140). He believed income taxes, especially when they discriminate against “unearned” income, e.g. taxes on capital and death duties, are as important as the rate of interest (Keynes, 1997:94–95). The multiplier effect of the fiscal variables was central to the Keynesian model, which enabled the analysis of alternative bundles of expenditure and tax amendments and the resultant consequence (Musgrave, 1985:47).

The capitalist system was considered volatile resulting in the level of demand being insufficient to maintain full employment (Arevuo, 2012:3). Keynes forwarded three recommendations to counteract the unemployment situation: the reduction of interest rates; active participation of the government in public investment activities and a progressive tax system that would redistribute income from the wealthy to the lower paid (Arevuo, 2012:3). During World War II, Keynes (Cooley & Ohanian, 1997:441; Keynes, 1939:4) suggested an income tax on the working classes with an increase in the tax rate to upwards of 15 percent in the United Kingdom. Depending on income earned the proposed taxes ranged from 20 percent to 80 percent (Keynes, 1939:8). Although these proposals were met with initial resistance, many of Keynes’s recommendations were adopted post World War II (Cooley & Ohanian, 1997:441).

Pressman (2014:148) highlighted the recent practical implementation of Keynesian policies during the late 2000’s when interest rates were reduced, governments increased spending and cut taxes to reverse the economic slump. Although these measures did not return the economies to full employment, these actions kept unemployment from rising to the Great Depression levels (Pressman, 2014:148). A number of economic theorists believed Keynes’s theories to be responsible for the current state of unemployment and poor economic growth being experienced with high progressive tax rates discouraging economic growth especially if levied on the working classes (Gale & Samwick, 2014:1).

### **3.6.6 Joseph Schumpeter (1883 – 1950)**

Schumpeter emphasised the role of the innovator i.e. inventor, developer, promotor whom he regarded as the energetic participants of capitalism (Samuelson & Nordhaus, 1989:871). Economics meant the study of change to Schumpeter who studied the short-run and long-run fluctuations or the phases and causes of business cycles (Pressman, 2014:148–149). He scrutinised the study of capitalism and was an ardent follower of Karl Marx and his predictions relating to the fall of capitalism (Pressman, 2014:152). In his article *Economics and Sociology of Income Tax*, Schumpeter referred to the term tax culture which he viewed as the degree of progressiveness and to the elegance of tax design (Nerre, 2001:3). Schumpeter’s understanding of tax culture focussed on tax economists, tax politicians and the national system

of taxation (Nerre, 2001:3). Although Schumpeter did not forward any major principles relating to taxation his pioneering public-choice theory in *Capitalism, Socialism and Democracy* (1942) indirectly affected taxation principles (Samuelson & Nordhaus, 1989:724;762). Schumpeter was concerned that taxation of profits, capital and wages would impact the economy, capital formation and growth adversely (Mair & Laramie, 1998:12) as it would counteract the expansion of production and industrial progression

### **3.6.7 Neoclassical Overview**

From the previous discussion it can be deduced that pure capitalistic markets or pure socialist systems were not promoted by neoclassical economists. These economists chose to argue their particular views but the generally accepted theory included tax equity and efficiency.

Following Keynesian economists and their theories, modern mainstream economists further focused on mixed capital economies (Samuelson & Nordhaus, 1989:827). An improved understanding of both macroeconomics and microeconomics led to an era of positive growth following World War II (Samuelson & Nordhaus, 1989:827). Modern economists search endlessly for methods to improve economic progress (Samuelson & Nordhaus, 1989:827) and the associated tax policies.

### **3.7 Twentieth century economists**

Twentieth century economists advanced the theories of the earlier economists and expanded on their views. These advancements were not restricted to capital markets only, but an increase in socialism was also observed (Mills, 1980:34). Neoclassical economists can be credited with the necessity of demonstrating the powers of expansionary policies during wartime and the demand for post war expansionary fiscal requirements (Musgrave, 1985:48) while, twentieth century economists debated the 'best fit' tax to facilitate redistribution of income necessary to achieve the optimal tax situation. Although the twentieth century is largely a capitalistic era, capitalism and free trade are not without shortcomings as a growing underground economy which represents unrecorded, informal or illegal economy has been noted (Samuelson & Nordhaus, 1989:832; Schneider, 2005:117). However, the underground economy has proved to be a major problem which needs to be addressed by adequate economic policy decisions (Schneider & Enste, 2002:2). The growing underground economy shifts the focus of taxation as the taxpayers in the tax net are penalised for the untaxed citizens (ACCA, 2017; Samuelson & Nordhaus, 1989:790; Schneider, 2005:127).

The first of the twentieth century economists to recognise the importance of taxation was von Hayek.

### **3.7.1 Friedrich von Hayek (1899 – 1992)**

von Hayek, an Austrian economist, received recognition as a champion of the free market and opponent of government intervention in economic affairs (Pressman, 2014:164–165; Samuelson & Nordhaus, 1989:828). He believed individual choice and free exchange through the market resulted in superior economic efficiency and greater liberty and freedom (Pressman, 2014:165). Hayek recognised the main problem with state intervention was the required knowledge being too great for government bureaucrats in a changing, uncertain world (Pressman, 2014:168). He believed government policy stifled economic growth rather than improve it. Hayek believed solutions should be forwarded for a dynamic rather than a static economy and any attempt to control markets would result in limited individual freedom, reduced economic efficiency and ultimately lower living standards (Pressman, 2014:170). Hayek emphasised the importance of stability and continuity in tax policy while providing an analysis of discriminatory taxation (Spicer, 1995:104). Hayek endorsed the proportional tax system believing progressive tax systems create more obligations between the worker and the growth of the economy (Estrada, 2010:5). He further criticised progressive tax systems for establishing a bias on economic wealth and affecting the incentives of the working population (Estrada, 2010:5). Hayek highlighted the contradictory nature of progressive tax systems with special emphasis on the imbalances promoted and the freedoms denied (Estrada, 2010:6). The redistributory aim of progressive tax systems proved unacceptable to Hayek (Radnitzky, 2000:5) who concluded that progressive tax systems do not disclose what the relative tax burden on individuals ought to be (Holcombe, 1998:363).

The outcomes reached by Hayek proved quite controversial as the foundation of taxation rests with revenue collected for public spending. Redistribution of income is an important aspect of taxation policy as the 'haves' are taxed at a rate that brings in sufficient revenue even though a large proportion of the population remains untaxed. The progressive versus proportional taxation debate can be seen throughout this historical journey with most economists advocating for a proportional rather than a progressive tax.

### **3.7.2 Jan Tinbergen (1903 – 1994)**

Tinbergen (1952:53) proposed government subsidies to “explore, appraise and stimulate private investment” so as to reduce unemployment. He believed the subsidy could bridge the gap between market profits and accounting profit for certain factors of production namely labour (Tinbergen, 1952:53). However, the downside to this would be an increase in taxes as this subsidy would have to be subsidised from tax revenue (Tinbergen, 1952:53–54). He also

observed the need to increase tax revenue would lead to an escalation in tax evasion (Tinbergen, 1952:54).

Traditional neoclassical theory advocated for the expansion of lump-sum taxes which could alleviate efficiency losses. This theory was advanced by Tinbergen with his proposal on a “tax on talent” which could only be imposed if governments knew enough about individuals to determine their lump-sum values (Plug *et al.*, 1999:185). Hundreds of macroeconomic models now exist for every country facilitating the study of future economic activity as a result of Tinbergen’s research (Pressman, 2014:196). These macroeconomic models help formulate economic policies with tax forming an integral part of these equations (Dornbusch *et al.*, 2001:28–29).

### **3.7.3 John Kenneth Galbraith (1908 – 2006)**

Galbraith objected to the trend of economic thought at the time as it assumed perfect competition and ignored the economic powers of large corporations (Pressman, 2014:211). Mainstream economists, at the time, assumed inflation was stimulated by a greater demand than the economy could satisfy causing the price of goods and labour to increase (Figura, 2003:18) while Galbraith believed this demand could be limited by fiscal and monetary policy which entailed reducing public spending, raising taxes and limiting private spending on credit (Figura, 2003:18).

Galbraith disapproved of the modern income distribution system even in wealthy nations and sought to defend the equalising effect of taxation principles (Galbraith, 1999:3). Having moved away from traditional economic tax theory, Galbraith concentrated on the effects of fiscal and monetary policy on inflation and the general well-being of the population (Galbraith, 1999:4; Pressman, 2014:214). He concluded the decisions made by large business corporations affected the inflationary policies in a country and this effect should be limited (Pressman, 2014:212). Galbraith’s principles were debated by economists of the time but Milton Friedman responded to the view of government intervention in manipulating fiscal and monetary policy decisions although he agreed with the conclusions reached relating to large corporate structures.

### **3.7.4 Milton Friedman (1912 – 2006)**

Friedman believed the two most important factors affecting economic activity are money and freedom. He also recommended government avoid any erratic expenditure or taxes (Friedman, 1982:79) as this defeats the redistributive purpose of taxes.

Like Galbraith, Friedman believed the tax structure imposed on corporations and individuals encouraged retention of corporate earnings (Friedman, 1982:130). A highly graduated income tax constitutes a serious impediment to the efficient use of resources as taxpayers seek devices to evade its impact (Friedman, 1982:133). The apt solution to this problem is the drastic downscaling of income tax rates, combined with an elimination of tax avoidance measures that have been incorporated into tax law (Friedman, 1982:133).

Among Friedman's significant contributions to economics was the idea of the 'negative income tax' in the 1950s. A negative income tax can be described as payment paid to the taxpayer by the government. The negative income tax signified a fundamental concept of modern welfare economics which would replace all other social programs (Ebenstein, 2007:174; Moffitt, 2003:2). A negative income tax operated on the refundable tax credit system which returned money to the taxpayer with reduced refunds as the taxpayers' income increased (Moffitt, 2003:3). However, governments were expected to provide certain benefits even when income was zero to maintain a certain standard of living for its citizens (Ebenstein, 2007:174; Moffitt, 2003:3). The work incentives of a negative income tax were evaluated by the comparison of its effects relative to a welfare program (Moffitt, 2003:3). The advantages of the negative income tax were efficiency and simplicity (Ebenstein, 2007:174).

In theory, the negative income tax can be considered ideal as it allowed refunds to taxpayers depending on the amount of income earned. It lends itself to the reduction of poverty as families are given a certain liveable amount as a matter of right not as charity. Supporters of this tax believed those benefiting from the tax would find incentive to work as the aim was to guarantee income without destroying the incentive to work (Moffitt, 2003:8). The negative tax system could increase the progressivity of a tax system when the trade-off between work incentives and costs are considered.

### **3.7.5 Paul Samuelson (1915 – 2009)**

Keynesian economics was popularised in America by Samuelson (Pressman, 2014:228) where economists were introduced to the multiplier effect, fiscal policy and the consumption function. Samuelson took the middle road and maintained the importance of both fiscal and monetary policy (Pressman, 2014:228).

Samuelson assessed the economic implications of expenditure and revenue and concluded the balancing effect will result in an equilibrium state. Economic theory was now evolving from the basic theorems of equity, efficiency and simplicity to more advanced research incorporating factors other than those affected by pure economic theory (Pressman, 2014:230).

### **3.7.6 Franco Modigliani (1918 – 2003)**

Modigliani is renowned for his contributions to macroeconomic theory. He developed the life-cycle theory of savings and consumption and helped formulate the Modigliani-Miller theorems to explain business behaviour (Pressman, 2014:232). In his life-cycle hypothesis, Modigliani showed demographic factors play an important role in explaining national savings behaviour but a temporary change in taxation will have a relatively small impact on lifetime income (Pressman, 2014:234) although it may have a fairly large impact on income when it occurs. However, tax changes are generally not temporary and could have far reaching effects on investments. The 1968 United States tax surcharge did not reduce spending and did not decrease inflation levels as was expected by Keynesian economists verifying the life-cycle hypothesis (Pressman, 2014:234).

### **3.7.7 James Buchanan (1919 – 2013)**

Economists expanded the study of taxation by the late twentieth century to include political factors and the various paradigms that were introduced by earlier economists. Buchanan extracted three important ideas from Wicksell's doctoral dissertation and spent his career expanding and developing these ideas (Pressman, 2014:238). Wicksell analysed taxation as an institutional decision, realised the need to adjust rules to alter fiscal outcomes and challenged the notion of an authoritarian rule and its usefulness to economic outcomes (Pressman, 2014:238).

Buchanan believed tax policy should be voted on by the public and further described his view on inefficient tax policies. Buchanan (1993:401) described an inefficient tax structure as one which reduces economic value to a potentially achievable level given the alleged resources and technological constraints within the particular politico-legal order. He argued the merits of a fiscal constitution which created a basic tax structure that could be altered only with substantial consensus (Holcombe, 1998:360). The need for publicly accepted tax policies can be identified as the politicians comprise a bare minimum of the population, most of whom are voted in by non-taxpayers (Besley & Smart, 2005:1). The current South African situation would fit perfectly into Buchanan's theory as the majority of the voting population are non-taxpayers. The government in power is therefore not representative of the taxpaying sector but allowed to impose tax policy on taxpayers (Besley & Smart, 2005:2).

Buchanan was awarded the Nobel Prize for Economics for his contribution on the study of governments and politicians (Pressman, 2014:238).

### **3.7.8 Douglass Cecil North (1920 – 2015)**

Economic growth is an important requirement in any state with tools to measure this growth being equally significant. North explained economic growth in terms of adopting the correct institutions and used statistical techniques to test theories which affect economic growth (Pressman, 2014:250). North believed institutions must enforce economic rules highlighting the economic role of the State in protecting citizens and businesses from robbery and extortion and ensuring honest tax collections (Pressman, 2014:252). The underlying principles of equity, efficiency and simplicity can be noted from North's deduction. However, he noted monitoring and enforcement costs tend to increase taxes which ultimately create economic disincentives and lowers economic growth (Pressman, 2014:253). In general terms, governments should establish an atmosphere where everyone plays by the economic rules without it being oppressive to any of the economic parties (Pressman, 2014:253).

These policies are compliant with Kautilya's (Section 3.3.1) and Yousuf's (Section 3.3.4.1) theory of taxation which sought to tax on a fair basis without penalising any sector of the economic structure. Fair taxation keeps distortions at a minimum while seeking to attain maximum revenue collection. In 1993 North received the Nobel Prize for his study of cliometric or new economic history.

### **3.7.9 Robert E. Hall (1943 – present) and Alvin Rabushka (1940 – present)**

Hall, a macroeconomist who refers to himself as an "applied economist" is most famously known for coordinating the principles of the flat consumption tax with Rabushka. Rabushka, an American political scientist is best known for his work on taxation and transition economies. Their joint research on the flat tax provided the intellectual foundation for numerous flat tax bills that were introduced in the United States of America during the 1980s and 1990s (Grecu, 2004:6).

The Hall-Rabushka flat tax converts the income tax into a national consumption tax (Feld, 1995:603). This system, if consistently applied to individuals and business entities creates an "airtight" mechanism where income is included in the tax base as close to the source as possible eliminates the opportunity for any misstatements of taxable income (Hall & Rabushka, 1995:38–41).

Hall and Rabushka (1995:59) proposed a flat tax of 19 percent on both individuals and businesses on wages, pensions and other compensation paid in cash for individuals. Dividends, interest and rent are not taxed in individuals' hands and they are allowed a primary standard

deduction or personal allowance (Feld, 1995:603). The income equation for individual taxpayers would then be:

$$\text{Income Tax} = \text{Flat Tax} \times [\text{Wages, Salaries, Pensions less Personal Allowance}]$$

(Greco, 2004:10).

(Greco, 2004:10) said of the Hall-Rabushka flat tax proposal:

[it] achieves simplicity, economic efficiency, and fairness — the traditional measures of effective taxation — while also collecting the revenues required to finance the government.

Although this theory has not been adopted in its original format, variations of this theory have been implemented which will be further discussed in Chapter Six.

### **3.8 Conclusion**

The complete family tree of economics would have to include all economists including those who did not propose changes to the tax laws which is beyond the scope of this work. A brief overview of the history of economics relating to taxation traces taxes in their earliest forms to present day tax principles.

The most important contributors economically in relation to tax hail from different eras with the first known taxes being levied in Ancient times in the form of corvée's and tithe's. In the Fourth century BC, Kautilya's Arthashastra provided the skeleton for the four canons of taxation which was followed by the feudal lords who levied different forms of taxes on their subjects and the eventual publication of the Magna Carta in 1215. A study of the contribution to the field of taxation by medieval Eastern economists highlighted the ability-to-pay, convenience, equity and efficiency principles (Section 3.3).

The early economists, the period between 1620 and 1790, were split into two definitive groups of economists referred to either as the mercantilists or physiocrats depending on their economic views. Mercantilists advocated for authoritarian control of economic policies and did not believe in the free market economy. Under Colbert, the French physiocrats reacted powerfully against the excesses of the mercantilists (Samuelson & Nordhaus, 1989:824). These early economists, particularly the physiocrats, were interested in the how, when and where of tax and its associated problems (Section 3.4).

The classical economists followed, the most popular being Smith, who proposed the four canons of tax which influenced all later tax theories. The family tree of economics then

branched into the Marxists and Neoclassical economists (Samuelson & Nordhaus, 1989:826). Vauban initiated exploration of the single tax proportional method long before Marx advanced the theory of socialism advocating a progressive tax system with the neoclassical economists studying government deficits, money supply and a means to promote economic progress (Samuelson & Nordhaus, 1989:827). The economists of the era between 1870 and 1914 were divided in their views on progressive versus proportional taxation and inheritance taxes (Schumpeter, 1986:912). Although certain leading academic authorities approved of high direct taxation, the opposing economists counter-argued the harmful effects of high, progressive tax rates and its effect on effort and capital formation (Schumpeter, 1986:912). However, the first modern income taxes were introduced during this era where a certain percentage of income was required to be paid over to the State in lieu of tax (Section 3.5).

The Keynesian Revolution followed with economic interest fixed on business cycles, the distinction between macroeconomics and microeconomics and its resultant effects. Modern economic theory is not without its own critics and their views on tax systems (Samuelson & Nordhaus, 1989:828). Unfortunately most taxation systems are inherently dependent on the prosperity of the nation for their success. Should there be an economic breakdown, the taxation systems will cease to perform adequately resulting in lower than expected revenue collections. Lower than expected tax revenue results in inadequate public expenditure programs and deficient redistribution of income, the two basic functions of a tax system.

The benefit theory as proposed by early economists, proved controversial with economists like Bentham proposing progressive rather than proportional taxation methods (Musgrave, 1985:17). Smith's fourth maxim highlights the importance of an efficient tax system (Section 3.5.1.5) coupled with the theories of equity, certainty and convenience. Although the utilitarian solution accepted the concept of least total sacrifice they warned against productional consequences of taxation that may outweigh distributional requirements (Musgrave, 1985:26). The subsequent modern interpretation of efficiency was proposed by Dupuit in 1844 and Gossen in 1854 (Musgrave, 1985:26). The DuPuit curve (Section 3.6) has become a popular measure of efficiency which is still used today. In 1871 Jenkin used supply and demand curves to demonstrate the relationship between the burden of tax and the amount of revenue collected (Musgrave, 1985:26). Although this extension of economic principles related to taxation, albeit controversial, was observed during the initial academic reporting, it remained fairly unnoticed.

The benefit principle was resurrected by Pigou (Section 3.7.5) in 1928 where he advocated the least sacrifice method as the ultimate tax principle (Musgrave, 1985:20). and laid the basis for the principle of optimum taxation highlighting the conflict between equity and efficiency (Musgrave, 1985:28). With the foundation for the theory of optimal taxation laid, the empirical

measurement of dead-weight losses for certain taxes were ascertained by Harberger (Section 3.7) in 1964 (Musgrave, 1985:28).

Early economists laid the foundation for the controversial concepts of equity with later economists highlighting the coexistence of the principle of efficiency. Differing economic views on the impact of proportional versus progressive taxation on equity were noted during this historical journey. The contentious topic of progressive versus proportional taxation was further debated in academic literature as was the theory of optimal taxation, factors closely related to basic economic principles. The significance of economic efficiencies together with political constraints has proved important to taxation policy and any reform to existing taxation policy. Historically, economists realised the importance of politics and demographic factors that affect the fundamental principles of equity and fairness as they relate to tax policy and commented on the trade-offs that may exist.

The following chapter will focus on the important economic aspects of equity, the subjective issue of fairness with related economic and non-economic factors and their impact on taxation. Related theories will be discussed to refine the study of equity and its associated concepts.

## **CHAPTER FOUR: EQUITY**

### **4.1 Introduction**

Economic history accentuated the fundamental concept of equity revealing associated unexpected economic variables that coexist to shape fundamental tax theory internationally. A study of equity would be incomplete without mention of the trade-off between equity and efficiency due to the importance contribution of political factors when examining tax policy.

A defining feature of any state is its ability to raise sufficient revenue through taxation (Baskaran, 2013:2). Taxation tacitly implies a transfer of revenue from the citizens to the state with implicit knowledge that the resultant effect of this transfer would benefit the taxpayer while redistributing income to promote equality. Any discussion on income tax would therefore be incomplete without a review of the economic principles that underpin the income tax system and tax policy. "The application of economic analysis to the problems of public policy" (Ahmad & Stern, 1989:1006), a subsection known as public economics, deals with tax systems that are designed to raise revenue in a manner where individuals are treated fairly with minimum interference in economic decisions without imposing undue administrative costs (Ahmad & Stern, 1989:1006; Alm, 1996:117).

Tax policy is ultimately a balancing act with the fundamental goal being a balance between equity and other related economic factors (Bird, 2003:4). Tax policy decisions, however, also need to incorporate administrative and political ideals embracing international norms and domestic factors (Bird, 2003:4; Tanzi & Zee, 2000:299). The levying of tax has three important functions; accumulation of revenue, a redistributive aspect and a regulatory function (Avi-Ronah, 2006:4; Renes & Zoutman, 2014:2). However, the redistributive function of taxation reduces the incentive of the less fortunate to work limiting the ultimate efficiency of the tax system (Piketty & Saez, 2012:8). The regulatory function of taxation aims to steer private sector activities in the direction required by the government (Avi-Ronah, 2006:4).

The previous chapter discussed the history of economics beginning with ancient and religious writings and their views on tax. The fundamental principles relating to tax policy and the contribution of economists were traced from the Fourth Century BC to present day economists. The principles of equity and fairness were found to be entrenched in the economic value system and affected directly or indirectly by a number of outlying factors. Although the principle focus of the chapter will expand on the principle of equity and fairness, related economic factors will be discussed for completeness. A discussion of optimal tax theory is included as the trade-off

between efficiency and equity is essential to this argument (Piketty & Saez, 2012:1). Slemrod (1990:157) further argued the existence of other critical issues relating to tax but not included in the theory of optimal taxation. He believed the collection of revenue by the State is coercive in nature and its implementation attracts added problems not adequately dealt with by the theory of optimal taxation (Slemrod, 1990:157). A study of equity and fairness is incomplete without a review of efficiency and its related principles consistent with objective two. The economic values of equity and efficiency are affected by issues which may not be purely economic in nature and these will be highlighted.

## **4.2 Basic economic principles of taxation**

With progressive lowering of trade barriers and increased globalization of financial markets the need for harmonization of tax systems is vital (Musgrave & Wilson, 1992:372). Citizens of one jurisdiction can move to another if they feel aggrieved with the tax policies in their resident jurisdictions. Tax policy considerations should therefore be based on equity, efficiency and administrability (Infanti, 2008a:1201) while considering tax policies of neighbouring jurisdictions. Tax policy decisions also affect foreign and domestic investment patterns impacting on economic growth (Khalilzadeh-Shirazi & Shah, 1991:xviii).

Historically various economists, as shown in Chapter 3, have advocated the principles of efficiency, equity and fairness together with the need to collect revenue as important factors when considering a tax system. An efficient, equitable and fair tax system would promote a state of optimal taxation which facilitates the collection of the required amount of revenue by the State.

## **4.3 Efficiency**

The meaning of efficiency is vital with the “Merriam Webster Dictionary,” (2017) defining efficiency as:

the state or quality of being efficient, or able to accomplish something with the least waste of time and effort; competency in performance.

Efficiency (Pasour, 1981:33) “is commonly understood as a performance standard where the goal is to achieve one’s purposes with the minimum of expense or effort”. Pasour (1981:34) further highlighted the difficulty in measuring efficiency accurately but advanced a measurement of efficiency as “a measure of useful output in relation to the value of inputs used”.

Economic efficiency is defined by Econlib as:

a relationship between ends and means. When we call a situation inefficient, we are claiming that we could achieve the desired ends with less means, or that the means employed could produce more of the ends desired. “Less” and “more” in this context necessarily refer to less and more value. Thus, economic efficiency is measured not by the relationship between the physical quantities of ends and means, but by the relationship between the value of the ends and the value of the means”

(Heyne, 2008)

Bourguignon *et al.* (2007:240) forwarded their definition of economic efficiency as being:

the largest possible value of output (or advantage, for this analysis) given a production possibility set.

Extrapolating from these definitions efficiency, in the tax context, would equate to a set of economic decisions which maximize the advantages while minimising distortions in a tax system.

#### **4.3.1 Tax Efficiency**

The concept of tax efficiency, introduced as early as 1776 by Adam Smith, implies “reducing to a minimum the tax system’s interference with economic decision making” (Infanti, 2008a:1201). Efficiency analysts tend to be prudent stemming from the concern relating to misallocation of resources (Bittker, 1979:737; Kaine *et al.*, 2017). Administrability of a tax system can be viewed as a component of achieving an efficient tax rather than as a separate tax policy goal (Infanti, 2008a:1202). An administrable tax diminishes compliance burdens on the taxpayer and reduces the costs of enforcing tax policies which ultimately results in a profitable, efficient tax system (Infanti, 2008a:1202). Tax administration should be coupled with the concept of efficiency as high administration costs result in reduced revenue for the State enhancing the state of inefficiency. Economic performance is associated with the measurement of inappropriate and unsustainable expenditure and a review of revenue policies in developing countries with a flawed tax system confirmed economic inefficiency (Thalwitz, 1991:xiii).

Buchanan (1993:401) analysed general taxation in the light of the interdependence between the rules of politics and the patterns of outcomes generated by the behaviour of taxpayers who act within those rules. He concluded a tax structure would be inefficient if it reduces economic value below a potentially achievable limit within the given constraints (Buchanan, 1993; Leviner, 2012:118). According to King (1980:1) a tax structure may contain incentive and disincentive properties resulting in efficiency losses or gains. Incentive allowances, a practice which

apparently augments tax revenue may actually be the cause of an inefficient tax system as these incentives encourage taxpayers to avoid and evade tax (Barreix & Roca, 2007:127).

Economic efficiency is further divided into allocative and productive efficiency (Osberg, 1995:13). Productive efficiency refers to the production of the maximum amount of goods from the available inputs (Osberg, 1995:13). Productive efficiency is not applicable to tax systems and will not be discussed further. Allocative efficiency is a key concept in analysing the performance of competitive markets (Samuelson & Nordhaus, 1989:548). Allocative efficiency has been shortened to efficiency and is defined as a state “when no possible reorganization can make anyone better off without making someone else worse off” (Samuelson & Nordhaus, 1989:548). Efficiency can also be described as a state that produces the maximum level of satisfaction with specific inputs and technology (Samuelson & Nordhaus, 1989:971). An efficient economy is organised in a manner that provides consumers with the greatest possible combination of commodities given the specified resources and technology (Leviner, 2012:106; Samuelson & Nordhaus, 1989:548). The various definitions of efficiency can be summed up using the “Merriam Webster Dictionary,” (2017) definition “the ability to do something or produce something without wasting materials, time, or energy”. Tax efficiency would, according to this definition, require an administratively proficient, inexpensive collection system capable of distributing its resources in an effectual manner.

Traditionally tax theorists considered the concept of equity (to be discussed later in Section 4.4) as the primary standard to be applied to the structural details of tax theory (Bittker, 1979:735). However, the goal of economic policy as regards taxation has been enhanced by the application of efficiency (Bittker, 1979:736; Kaine *et al.*, 2017). When taxation theory is being investigated, efficiency would be associated with administrative competence and the proficient allocation of tax resources (Bittker, 1979:736; Kaine *et al.*, 2017). This leads to the discussion relating to tax allowances and incentives and their role in tax efficiency models. Efficiency theorists therefore enquire “whether the tax allowances of existing laws promote or inhibit the efficient allocation of resources” (Bittker, 1979:736).

Traditionalists justified the differentiation in tax rates, that is, progressive taxation, as the principle of least aggregate sacrifice amongst persons who are utility generators (Buchanan, 1993; Leviner, 2012:118). The traditionalist argument reappeared in the 1970s and 1980s as the principle of optimal taxation suggesting the possible efficiency gains when tax rates differ (Buchanan, 1993). Traditionalist theory supports a redistributive theory where citizens with higher financial means bear a higher burden of taxation (Leviner, 2012:118). Many economists debated the issue relating to the efficiency status associated with progressive versus proportional tax systems. There is currently very little consensus regarding the issue of

progressive and proportional taxation. According to Sørensen (1993:19) progressive tax rates result in inefficiency due to the difference in the resultant after-tax income following the taxation of capital income. Higher rates of taxation could disincentivise economic activity among high income earners (Leviner, 2012:118) while progressivity causes the marginal rate of substitution between future and present consumption to differ between taxpayers resulting in an inefficient allocation of level of savings (Sørensen, 1993:19).

In the alternate, less conventional normative analysis, the distribution of taxes is treated in conjunction with the budget making the connection between taxation and spending (Buchanan, 1993). This approach justifies the differentiation in taxation rates in conjunction with the demand intensities of goods and services (Buchanan, 1993; Leviner, 2012:130). However, fiscal economists tend to ignore politics and presume governments aim for efficiency in taxation and are successful (Buchanan, 1993).

The basic efficiency theory is more explicit and presupposes an increase in “tax-favoured behaviour” as compared to the unfavoured alternative resulting in an equalization of after-tax benefits (Bittker, 1979:738; Leviner, 2012:130). Bittker (1979:738) referred to this as the “equalisation assumption” which is as dominant when assessing efficiency theory as it is damaging to equity theory. Although this behavioural assumption is seldom used as a standard for judging efficiency (Bittker, 1979:738), Leviner (2012:130) highlighted the important differences between the theories determining that the key purpose of all theories to intervene in the free-market economy. A logical conclusion would indicate efficiency is measured depending on which school of thought, either normative or the fiscal approach, is employed. However, the benchmark for an efficient tax system cannot refocus depending on the school of thought in that period. Modern economists have tried to effectively solve the efficiency debacle without being associated with a particular economic school of thought. Modern tax systems are required to accommodate other pertinent factors essential for the functioning of a market-related economy. As tax structure is multidimensional, political factors may sway tax rates and tax systems to a large degree which may influence the eventual efficiency of the tax system (Profeta, 2003:6) with an important consideration being the deadweight loss of a tax policy. As deadweight loss determines the ultimate efficiency of a tax system, a brief discussion is included.

#### **4.3.2 Deadweight Loss**

When considering efficiency an important question would be:

What is the tax structure that seems most likely to yield the relatively most efficient pattern of outcomes? (Buchanan, 1993)

Buchanan (1993:403–404) considered two alternative explanations: the empowering of legislative authorities to impose a tax system without specific constraints or legislative majorities constitutionally constrained with regards to the application of the distribution of taxes. The two areas of consideration proposed were the imposition of taxes and the redistribution of these taxes which consumed the minds of many economists (Bittker, 1979:735) with efficiency theorists distinguishing between after tax returns and misallocated resources.

General taxation is politically and constitutionally efficient if it produces legislative outcomes that minimize the impairment of economic value (Buchanan, 1993). To demonstrate the efficiency of a particular tax, economists delved into the basic structure of supply and demand curves. In an efficient economy, the marginal rates of substitution for any two products will be identical to the marginal cost of transformation (Elkins, 2006:47). In this instance, the efficient economy is devoid of taxes. However, taxes create inefficiencies due to the substitution effect causing taxpayers to choose an option that carries a lower tax burden resulting in a deadweight loss to society (Elkins, 2006:47).

Deadweight losses or the excess burden of taxation result in proportional economic inefficiencies that distort taxation related economic decisions (Auerbach & Feldstein, 2002:1349; Elkins, 2006:47). Deadweight losses, as depicted in Figure 4-1 (also discussed in Section 3.6), relate to the loss of efficiency associated with utility and is described as the loss of total welfare or social surplus due to externalities such as taxes, subsidies and monopolies. This study will review the deadweight loss from taxes only.

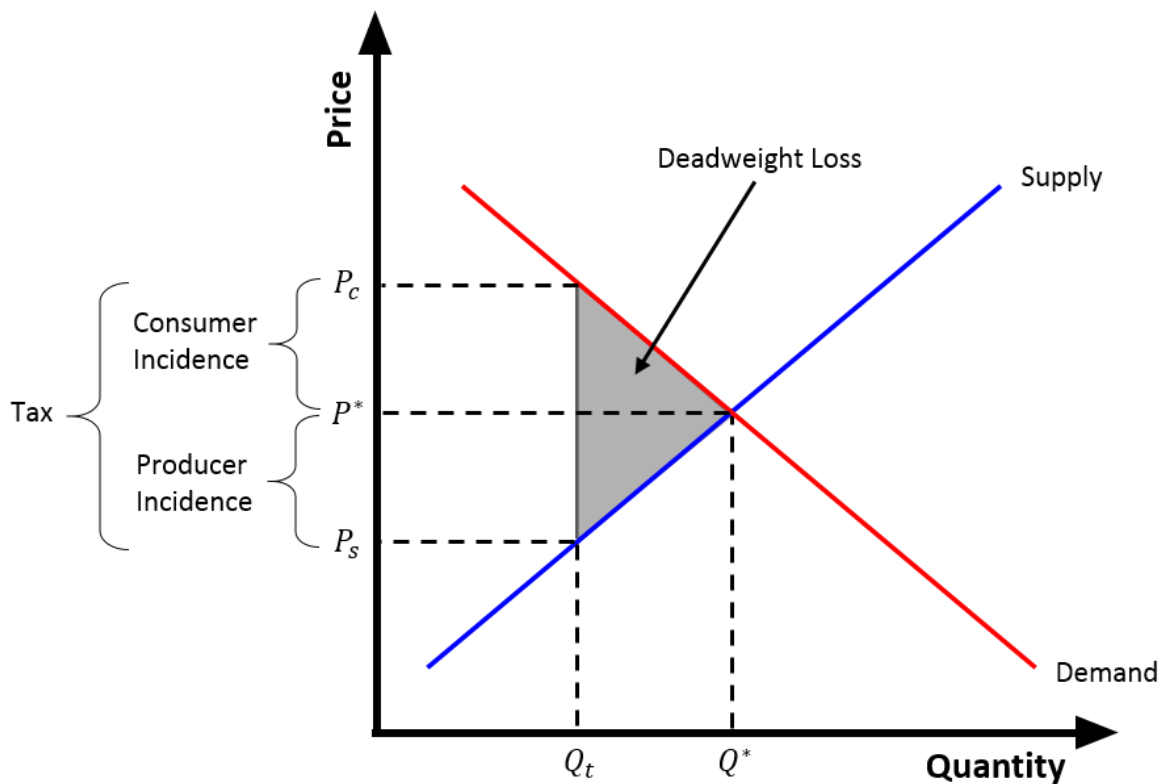
The area of the deadweight loss (Figure 4-1, shaded area depicted as consumer incidence) represents the consumer satisfaction that has been lost due to the higher value of the commodity post tax (Hines, 1999:169). Distortions such as taxes affect the equilibrium between marginal benefits and marginal costs preventing mutually beneficial transactions (Hines, 2002:2). The height of the Harberger triangle represents the distortionary tax rate; the base of the triangle the amount by which sales fall and the area is referred to as the deadweight loss a measure of efficiency (Hines, 2002:2).

The Harberger method provided an empirical calculation of economic efficiency. The measurement of deadweight loss was proposed by Harberger as:

one-half times the product of the price change times the quantity change corresponding to the theoretical amount of the welfare change (Hausman, 1981:662).

Although Harberger refers to a price change this represents in this instance a change in the tax rate. If the tax rate increased the corresponding loss in revenue would be equivalent to the

deadweight loss (Hines, 2002:169). The deadweight losses can be reduced by moderating the substitution effect which requires the imposition of an identical tax burden on every course of action available to the taxpayer (Elkins, 2006:47).



**Figure 4 - 1: Deadweight loss of taxation**

(economics.accounting-coach.com)

The study of tax efficiency analyses the elasticity of the tax base when individuals are able to change their behaviour to avoid tax (Elkins, 2006:49). Narrower tax bases tend to be more elastic resulting in a higher level of tax avoidance (Elkins, 2006:49). However, a tax on income would result in a broad tax base as income incorporates both consumption and investment (Elkins, 2006:50). Tax systems should be efficient enough for the government to secure the revenue by preventing tax leakage and the possible growth of the shadow economy while allowing taxpayers the ability to comply with the requirements (ACCA, 2009:6). To achieve the objective of increasing revenue to its maximum the elimination/reduction of the deadweight loss is vital as this would result in increasingly efficient tax policies. The attainment of efficient tax policies requires a review of the total tax burden to the taxpayer. The total tax burden faced by the taxpayer includes both the amount paid as taxes and any lost economic value from inefficient activities related to taxes (Hines, 2007:1). The direct tax burden is the amount of revenue remitted by taxpayers to governments while the efficiency costs are represented by the

magnitude of economic costs related to the economic distortions (Hines, 2007:1). Economic distortions are higher when tax rates are higher resulting in an increased excess burden and ultimately an inefficient tax system (The Davis Tax Committee, 2014:4).

Although the definition of income is considered paramount to the study of efficiency, the administrative applications of income tax are also important. A tax system that requires a high level of administration from both the fiscus and the taxpayer tends to result in inefficiencies due to the complex administrative information required (The Davis Tax Committee, 2014:5). This could result in tax evasion and a growing shadow economy especially in developing countries. The concept of income and its importance will be discussed in section 4.3.3.

### **4.3.3 Income versus Consumption**

Income is a vital component of the tax system as, in most instances, it determines the approach to taxation policy. Tax may be levied on income or on consumption or both depending on the approach to tax policy issues. Tax levied on income is a controversial subject as it can be levied on either income earned or income earned and savings resulting in different outcomes for the taxpayer (Barreix & Roca, 2007:127; Brooks, 2018:256).

The distributional fairness of any tax system is dependent on income and its classification (Armour *et al.*, 2013:2). However, the definition of income is dependent on the data available to the fiscus resulting in this being a limiting factor (Armour *et al.*, 2013:2; Brooks, 2018:257). The definition of income used by any State affects the type of tax levied and total revenue collection. Concise definitions of income were offered independently by Haig and by Simons which when combined became the most widely used definition of income.

Robert Murray Haig (1921:27) defined income as

the money value of the net accretion to one's economic position between two points of time.

while Henry C. Simons (1938:50) defined personal income as

the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.

The theoretical advantages of this definition of income involved the inclusion of all income with specific personal deductions (Alm, 2018:2) serving the interests of horizontal equity coupled with progressive marginal rates which confer vertical equity (Barreix & Roca, 2007:126). When

financial capital is taxed at higher marginal rates, taxpayers tend to shift wealth to lower tax jurisdictions thereby annihilating both horizontal and vertical equity principles (Barreix & Roca, 2007:127). This problem is multiplied by the administrative complexities of the associated deductions resulting in higher administrative and compliance costs (Barreix & Roca, 2007:127) ultimately impacting on efficiency costs (Alm, 2018:8) .

Depending on its implementation horizontal and/or vertical equity principles, administrative and compliance issues may not be achieved (Alm, 2018:10; Barreix & Roca, 2007:127). An administratively complex definition of income results in a complicated system of taxation with a resultant loss of efficiency (Barreix & Roca, 2007:127).

An alternate definition of income was advanced by Hicks in 1939 where he stated income should be the maximum value that a man can consume within a specified period and still be as well off at the end of the period as he was in the beginning (Reich, 1991:237; Sefton & Weale, 2005:1). The Hicksian definition of income depended on expectation and permanence which resulted in practical tax application difficulties (Fjaerli & Aaberge, 1999:8).

Haig later suggested a consumption approach based on the value of goods and services from which utility was obtained, an income approach based on monetary and non-monetary receipts and imputed income from the taxpayer's personal efforts and assets (Alley & James, 2005:7). Tax policy debates are largely centred upon the imposition of the tax base i.e. whether it should be consumption based or accretion based (O'Kelley, 1981:1). A consumption based tax would comprise a tax based on personal consumption only while an accretion based tax is based on the sum of personal consumption and a net increase in wealth (O'Kelley, 1981:1). A further downfall of the accretion based method is the resultant multiple taxation of savings (Saxton, 1999:4). Mill (1874:406-409) viewed taxation on income without any exemptions for saving as discriminatory since investors are taxed at least twice, once on income earned and secondly on the proceeds from the investment (Gunn, 1979:372).

Although the tax structure defines the economic efficiency of the resultant tax the administrative efficiency (The Davis Tax Committee, 2014:4) is equally important as a good tax structure would not be useful if administrative principles were lacking as portrayed by Bird (2004:134):

The best tax policy in the world is worth little if it cannot be implemented effectively.

The specific definition of income used to determine tax payable by the taxpayers establishes a similarity of capacity to contribute to the welfare of the State (Klein, 2014:457). The definition of income, however, determines the total revenue and administrative efficiency of the system (Bird, 2004a:135),

In summary: a variety of different definitions of the term income exist, as can be noted from the discussion above, resulting in a choice which is made by the State not the taxpayer. Tax can be levied on income, consumption, income and consumption, labour income and capital income. However, the choice of the definition of income is a policy decision that should address the principles of efficiency; equity and simplicity. A further impasse particularly prominent in developing and transition countries is the economic and administrative efficiency of the tax system. Following the accidental discussion of efficiency a comprehensive analysis of the principles of equity follow.

#### **4.4 Equity**

Equity has been defined by the “Merriam Webster Dictionary” (2017) as:

fairness or justice in the way people are treated.

Fairness, however, is a moral and social concept that is shaped and moulded as individuals observe patterns and behaviour of other persons (Che Azmi & Perumal, 2008:12). AICPA (2007:2) emphasised the difficulty experienced in formulating an objective definition of equity and fairness. Although the distribution of rewards and resources are commonplace in societies with the resultant allocation of resources according to fair and just principles being an important social activity, judgements on fairness can be quite subjective (Alesina & Angeletos, 2003:3). Considerable research on perceived fairness resulted in the conception of the theory of equity. Although most definitions of equity are rather narrow, Webster’s Third New International Dictionary (cited in Leventhal, 1977:3) defined equity as:

a free and reasonable conformity to accept standards of natural right, law, and justice without prejudice, favouritism, or fraud and without rigor entailing undue hardship.

This expands on the earlier narrow definition of equity. However, an even broader definition was quoted by Coetzee (1995:32) where equity was defined by Feldman as:

[d]epending on the user's inclinations, 'equity' can mean almost anything.

Whereas Bourguignon *et al.* (2007:236) defined equity in terms of two principles:

(a) equal opportunities and (b) avoidance of extreme deprivation in outcomes.

Democratic societies regard equity as an important factor when designing tax policy albeit a controversial concept (Genser, 2006:72; Repetti & Ring, 2013:135). In legal terms, ‘equity’ is defined as:

the recourse to principles of justice to correct or supplement the law as applied to particular circumstances (Infanti, 2008a:1195)

Tax equity, however, considers economic differences in determining the fairness of a tax system and performs a screening function which ignores non-economic differences among the population (Infanti, 2008a:1195).

It is widely agreed that comprehensive income is the socially accepted indicator of a taxpayer's "ability-to-pay" and is a transparent, reliable and simple method of calculating equitable annual income for taxation purposes (Genser, 2006:272). Two redistributive principles comprise equity which dominate the influence of government policies (Duclos, 2006:2). Vertical equity assesses the equity of the impact on individuals who are unequal and horizontal equity serves to assess the equity of the impact on individuals who are regarded as equals (Duclos, 2006:2). The vertical component for taxes is a measure of the extent to which the tax burden is transferred from low income to high income taxpayers (Bjorklund *et al.*, 1995:233) while the horizontal component is measured as the reranking that occurs pre- and post-tax.

A discussion of horizontal equity and vertical equity as separate but correlated entities is required.

#### **4.4.1 Horizontal Equity**

Horizontal equity necessitates the equal treatment of equals whereas vertical equity requires an "appropriate pattern of differentiation among unequals" (Repetti & McDaniel, 1993:607). The theory of horizontal equity demands taxpayers who are equally well-off should pay the equivalent amount of tax irrespective of how they earn their income (Elkins, 2006:47). Horizontal equity is concerned with the well-being or welfare of the taxpayer in contrast to efficiency which is concerned with the elasticity of the tax base (Elkins, 2006:50). The principle of equal sacrifice forms a basic building block of the concept of redistributive justice relating to taxation principles (Sheffrin, 1993:301). However another core value relates to the principle of equal benefit and both these should be analysed jointly to achieve both horizontal and vertical equity.

Musgrave commenced research on equity with the assumption that horizontal and vertical equity "are but different sides of the same coin" (Repetti & McDaniel, 1993:607). In 1959 Musgrave deduced that:

An objective index of equality and inequality is needed to translate either principle into a specific tax system (Repetti & McDaniel, 1993:608).

Although this concept was formally identified by Musgrave, the concept can be traced back to Mill who stated that a:

tax system ought to demand an equal tax burden from taxpayers with equal capacity to contribute (Galle, 2008).

In 1989 Kaplow resolved unlike Musgrave that horizontal equity had no significance (Repetti & McDaniel, 1993:608). Musgrave maintained the tax policies that produced better horizontal equity should be preferred (Repetti & McDaniel, 1993:609).

Musgrave argued that in an ideal world both vertical and horizontal equity will be satisfied but in the real world trade-offs between horizontal and vertical equity must be considered when analysing proposed tax policy changes (Repetti & McDaniel, 1993:609). Kaplow further retorted that horizontal equity merged into vertical equity and maintained an appropriate system of differentiating between unequals is an essential requirement when analysing vertical equity (Repetti & McDaniel, 1993:610/612). Elkins (2006:51) subsequently argued that horizontal equity cannot be derived from vertical equity as the redistributionary theories of vertical equity are end-state theories which do not consider pre-tax market distribution when evaluating post-tax distributions. End-state theories do not consider the taxpayer's position in the original distribution (Elkins, 2006:52). According to Elkins (2006:53) if two taxpayers were initially equally well-off and redistribution created an inequality between them, utilitarian theory would be indifferent to this violation of horizontal equity.

Musgrave (1990:114) concurred with Kaplow regarding the measurement of tax equity which must be established based on entitlement and distributive impartiality. Historically, economists have endeavoured to achieve equity when advancing tax policy principles. Smith was regarded as the "ability-to-pay theorist" with his first and second maxims, although they appear to contradict each other but satisfied both the ability-to-pay and benefit components of equity (Musgrave, 1990:114). Mill (1848) using the assumption of identical utility functions and declining marginal utility of income concluded that those with identical incomes should be taxed identically and those with higher incomes should be taxed at a higher tax rate (Musgrave, 1990:115). These principles would favour a system of progressive taxation. Although Smith and Mill employed the entitlement principle, Bentham's utilitarian model arranged distribution in an optimal manner (Musgrave, 1990:115). However, the utilitarian target of "least aggregate sacrifice or maximum welfare" was achieved in 1928 by Pigou (Musgrave, 1990:115).

Musgrave's post reassessment of his earlier conclusions, deduced that the requirements of horizontal equity remained essentially unchanged under the various formulations unlike vertical equity which transformed under the different approaches (Repetti & Ring, 2013:137).

The horizontal equity concept of "equal treatment of equals" was further analysed with Feldstein (1976) interpreting it as the treatment that results in individuals who were equal pre-tax being equal post tax (Balcer & Sadka, 1986:81). The ideal tax system should preserve the utility order implying that any two taxpayers with a specific utility level in the absence of taxation should have the identical utility level in the presence of taxation (Duclos *et al.*, 2003:4). Horizontal equity principles in this instance implied taxpayers should be identified as equals both pre- and post-taxation.

A further theory pertaining to the measurement of horizontal equity was forwarded by J S Mill. The sacrifice theory, often referred to as the stepchild of Utilitarianism, proposed the goal of minimum total sacrifice to achieve maximum total utility (Elkins, 2006:56). Despite the varying theories and views on the principles of horizontal equity, Atkinson and Stiglitz maintained:

The principle of horizontal equity states that those who are in all relevant senses identical should be treated identically

(Balcer & Sadka, 1986:81; Galbiati & Vertova, 2008:385).

The implementation of this definition further raised the issues of relevance and equality (Galbiati & Vertova, 2008:386). Galbiati and Vertova (2008:385) believed that the normative debate relating to this concept should focus on the appropriate definition of equality rather than on the definition of 'horizontal equity'.

#### **4.4.1.1 Equality**

Equality is defined in the "Merriam Webster Dictionary" (2017) as:

the quality or state of being equal: the quality or state of having the same rights, social status etc.

Equality, as concluded by Coetzee (1995:25), refers to a "precise measure being repeated in the two value items that are compared". Equality can be identified as a state that enables an identical result when different value items are measured and compared (Dworkin, 1981:189). Although equality has a mathematically correct association, the principle of equity lacks this mathematical correctness (Espinoza, 2007:346). The principles of equality and equity although very similar cannot be used interchangeably (Espinoza, 2007:345).

The 'equity' concept is associated with fairness or justice ..... and it takes individual circumstances into consideration, while 'equality' usually connotes sameness in treatment by asserting the fundamental or natural equality of all persons

(Espinoza, 2007:345)

Balcer and Sadka (1986:81) interpreted the concept of horizontal equity as equals not having to pay the same tax but as equals enjoying the same utility. They further expanded on the principle by implying different family sizes should be taken into account using the utility theory (Balcer & Sadka, 1986:81). The concept of horizontal equity, where equals should be treated equally, either in relation to income or utility measures provides a basis for tax policy design. However, Repetti and Ring (2013:138) believed horizontal equity, although not a useful instrument in tax policy design may prove useful in establishing the tax policy design process and the assessment of the administrative processes. Horizontal equity necessitates the distributive justification of tax policy changes that impose unequal taxes and serves as a benchmark for assessing the fairness of tax laws (Repetti & Ring, 2013:138). The requirements for vertical equity can vary considerably while those for horizontal equity remains essentially stable resulting in various authors (Balcer & Sadka, 1986; Hettich, 1983; Stiglitz, 1982) advocating the distinct treatment of horizontal equity as a separate principle when advancing tax policy (Duclos *et al.*, 2003:4). Espinoza (2007:349) deduced the basic problems of the equity theory as:

it employs a one-dimensional concept of fairness and emphasizes only the fairness of distribution, ignoring the fairness of procedure.

The equality concept was further analysed by John Rawls who believed equality to be an end in itself and developed the 'difference principle' (Elkins, 2006:54; Espinoza, 2007:346). The desired outcome of this principle would maximise the welfare level of the least well-off individual (Elkins, 2006:55). He further justified the welfare of the rich as that which contributes to the welfare of the poor (Elkins, 2006:55). Rawls methodology also concluded that rational individuals would endeavour to maximize the welfare level of the most deprived segments of society (Elkins, 2006:55). However, the Rawlsian redistribution principle does not conform to the principles of horizontal equity (Elkins, 2006:56) but rather to those of vertical equity.

The Mill's theory was not accepted by Utilitarians who contended when two taxpayers suffered similarly in paying taxes there was no link to total utility loss (Elkins, 2006:57). Wealthier taxpayers have a lower marginal utility which results in the same amount of revenue being raised with reduced overall sacrifice (Elkins, 2006:57).

#### 4.4.1.2 Revised Definition

A number of economists disputed the exact meaning of horizontal equity, whether it had normative content or what this principle required of policy-makers (Galbiati & Vertova, 2008:384). Musgrave (1990) believed the principle of horizontal equity had firmly grounded normative bases while Kaplow (2000) concluded that any measurement of horizontal equity would be useless and perhaps harmful for policy makers if it were a risky principle (Galbiati & Vertova, 2008:384). Horizontal equity, according to Lambert (2004:39) should offer “protection against arbitrary discrimination” while echoing the basic principles of equality. Lambert (2004:42) dissected the definition resulting in the isolation of two problems, the first being the definition of equals and the second the meaning of equal treatment. Galbiati and Vertova (2008:389) resolved the traditional analysis of horizontal equity is flawed and suggested the alternative of “normatively appropriate equals” be selected. When normatively appropriate equals are selected for a certain policy there is no discrimination between the individuals resulting in the policy being horizontally equitable (Galbiati & Vertova, 2008:389).

A revised definition of horizontal equity was proposed by Galbiati and Vertova (2008:389):

The individuals treated equally by a policy should be those who are deemed normatively equals

The myriad of definitions by various economists, ancient and modern, concluded the equal treatment of taxpayers should be assessed both pre- and post- tax irrespective of which method is employed. A more recent notion of horizontal equity suggests the relative positions of both before and after tax income be maintained for horizontal equity to be attained (Berliant & Strauss, 1985:180). Galbiati and Vertova (2008:388) further analysed the concept of horizontal inequity concluding this is the state when horizontal equity is violated that is when ‘equals’ as defined are discriminated against.

Horizontal equity should be used to determine the fair distribution of tax policy (Cordes, 1999:195; Espinoza, 2007:349). The concept of taxation is in itself multifunctioning resulting in the principle of horizontal equity assuming different meanings for different tax functions (Galle, 2008). Horizontal equity protects taxpayers against arbitrary discrimination and is consistent with the principles of equal worth (Cordes, 1999:195). Certain tax scholars believe horizontal equity is subordinate to vertical equity (Cordes, 1999:195). However, when the tax action of equal treatment for equals is critically analysed it could be concluded that horizontal equity ensures the distribution of tax burdens in a vertically equitable manner (Cordes, 1999:195).

Historically, the importance of the concept of horizontal equity as it relates to tax policy has been adequately demonstrated.

An ideal tax base underpins the horizontal equity concept (Mirrlees, 2010:555). Two approaches have been forwarded, the total (Haig-Simons in Section 4.3.3) income approach which is argued to be the best measure of ability to pay and the annual consumption method argued by Kaldor in 1995 which maintains it is horizontally equitable to tax on what is taken from the economy (consumption) rather than a measure of income (Mirrlees, 2010:555).

Comprehensive income calculations ensure citizens are equally well-off before and after taxation consistent with the principles of horizontal equity (Genser, 2006:272). Comprehensive income tax further facilitates the use of a graduated income tax which guarantees vertical equity in keeping with socially acceptable after tax distribution (Genser, 2006:273). However, although the importance of horizontal equity has been echoed by Musgrave from 1959, there are numerous unresolved issues pertaining to this principle (Galbiati & Vertova, 2008:384). Horizontal equity implies the equal taxation of taxpayers with a similar ability to pay, with this utilitarian notion of equalizing sacrifice presupposing knowledge of individual tastes and preferences which Hayek termed “a regrettable mistake” (Hayek, 1960:309).

Horizontal equity should not be considered in isolation as there are numerous underlying factors that affect the concept. A study of the principle of vertical equity follows in an attempt to shed more light on the concept of equity.

#### **4.4.2 Vertical Equity**

As the analysis of government policies are impacted by two broad redistributive principles, vertical equity and horizontal equity, the study of both these are important. Vertical equity:

serves to assess the equity of that impact on individuals with differing initial levels of well-being (Duclos, 2006:2).

Vertical equity, as opposed to horizontal equity, entails differentiation among unequals or the equitable treatment of those faced with different circumstances (Lambert, 2004:39; Samuelson & Nordhaus, 1989:974). Lambert (2004:39) referred to vertical equity as being “a matter of societal taste” which requires “a value judgement”. Unlike horizontal equity which commands a normative approach, vertical equity falls into the category of positive economics (Lambert, 2004:40). The normative approach considers ethics, value judgements and goals of public policy whereas positive economics describes the facts and behaviour in the economy.

Berliant and Strauss (1985:182) deduced vertical equity related to a comparison of the after-tax income distributions. According to this theory, the measure of vertical equity is essentially that of after-tax-income inequality (Berliant & Strauss, 1985:182). Measures of vertical equity involve both pre-tax and post-tax positions combined with comparisons of taxpayers who are not equals (Berliant & Strauss, 1985:182). According to Galle (2008:1324) the concept of vertical equity relates to societal distributive justice which embodies the concept of tax fairness. However, the modern formulation of vertical equity rejects the utilitarian assumptions based on the space of utilities in favour of capabilities (Duclos, 2006:3) resulting in the 'maxi-min' Rawlsian rule being advanced by Rawls in 1971:

All social primary goods – liberty and opportunity, income and wealth, and the bases of self-respect – are to be distributed equally unless an unequal distribution of any or all of these goods is to the advantage of the least favoured (Duclos, 2006:4).

In 1985, Sen interpreted Rawl's primary goods as capabilities and defined equity in a capability space from which individuals could choose (Duclos, 2006:5). Sen construed an alternate theory to the utility theory namely the capability theory where individual welfare is measured by the things people can do and can do well (Pressman, 2014:276). As a welfare economist, Sen demonstrated the positive effects of improving human potential by improving the lives of the less fortunate with easy access to food, healthcare and education (Pressman, 2014:276). This affects the redistributory function of taxation where the rich are taxed more to ensure redistribution tasks are effective. The implementation of this redistributory function influences the vertical equity principles of tax policy design.

With the ultimate aim of tax policy design being the implementation of a fair tax system, tax theorists have left the term fair tax undefined (Schurtz, 1986:1671). Fair tax could be interpreted as progressive, proportional or a regressive tax system (Schurtz, 1986:1671) depending on personal views and beliefs. The early economists believed a fair tax can be achieved within the realms of the ability-to-pay and benefit principle of equity (Osberg, 1995:11; Schurtz, 1986:1671). When assessing the principles of a fair tax numerous aspects need to be considered.

An important factor is the measurement of inequality which is defined as:

an unfair situation in which some people have more rights or better opportunities than other people. (Merriam Webster Dictionary, 2017)

However, the measurement of inequality, as per the definition of vertical equity, depends on the lifetime or annual measurement of income (Osberg, 1995:11). Measurement of income is

dictated by the population being examined and the method of dispersion being used with some measures being more sensitive than others (Osberg, 1995:12). The measurement of income determines the application of vertical equity principles. Vertical equity could be applied to progressive, proportional and regressive tax systems utilizing the slope of the marginal utility graph (Repetti & McDaniel, 1993:610). Numerous economists believe vertical equity is achieved when a progressive tax rate is levied (Infanti, 2008b:2). The tax system to be utilized will be dependent on the elasticity of the marginal utility of income with respect to income that is greater than, equal to or less than one (Repetti & McDaniel, 1993:610).

Mitra and Ok (1997:316) referred to the 'principle of progressivity' and asked the fundamental question "are all progressive taxes equitable?" This criterion which became known as the principle of progressivity states:

An income tax function should decrease income inequality (in the sense of relative Lorenz dominance) for any given pre-tax income distribution (Mitra & Ok, 1997:316).

In answering their own question, Mitra and Ok (1997:317) initially reformulated Mill's maxim of income "taxation so as to inflict equal sacrifice" to "An income tax function must yield equal sacrifice to all individuals relative to at least one acceptable social norm (or, a utility function for the representative agent of the society)". They proceeded to investigate progressive taxation and concluded that:

a progressive income tax need not be equal sacrifice; one rather needs the marginal rate progressivity to ensure that equal sacrifices will be imposed upon all (relative to a permissible utility function) (Mitra & Ok, 1997:318).

With the primary goal of vertical equity being the taxation of each taxpayer's 'fair share of income', the definition of fair share should be easily defined (Schurtz, 1986:1671). However, the concept of ability-to-pay has been utilised and forwarded as the:

capacity for paying without undue hardship on the part of the person paying or an unacceptable degree of interference with objectives that are considered socially important by other members of the community (Schurtz, 1986:1671).

Vertical equity influences the fairness of a tax system which depends on the definition of income used when considering an income tax (Mitra & Ok, 1997:317). While most economists and policy-makers believe a progressive tax system satisfies the vertical equity concept this is not necessarily correct as other taxation systems could be modelled to satisfy vertical equity

principles. An important concept when analysing vertical equity is the principle of Pareto Optimality or Cost-Benefit Analysis.

#### **4.4.3 Cost-Benefit Analysis**

Although the cost-benefit analysis theory is widely used as a sound theoretical concept that enables the researcher to investigate the theoretical advantages of costs versus benefits, the practical and ideological issues prove more difficult. Practically, relevant data proved challenging to obtain while ideologically the technical and utilitarian aspects proved unappealing to politicians (Posner & Adler, 1999:171).

Pareto (Section 3.7.2) proposed a principle of evaluation, the Pareto principle, which introduced the notion of an optimal state subsequently referred to as “Pareto Optimality” (Pressman, 2014:110). The Pareto Principle required compensation to individuals for differences in their abilities. The Pareto principle also referred to as the 80/20 rule, stating that 20 percent of the invested input is responsible for 80 percent of the output (Rungie, 2002:1431). This principle further seeks to respect individual preferences when commanding social decisions and relies on the concept of improving the state of at least one person without decreasing the state of another (Kaplow, 1995:498; Posner & Adler, 1999:170). Theoretically this concept proved successful but practically it is difficult to assess the preferences of an individual objectively resulting in the compensation theory proposal by Kaldor and Hicks in 1939. The compensation theory held that the test will be valid provided the beneficiaries were enriched enough to overcompensate those who were injured by the proposal (Posner & Adler, 1999:170). Persky (2001:200) further observed:

The Kaldor-Hicks criterion argued that a public policy was justified if it produced social gains in excess of social losses so that it was possible for winners from the policy to compensate losers—even if such compensation did not actually occur.

This principle enabled economists to comment on efficiency by ignoring equity principles. The Kaldor-Hicks method also lacked distributive effects and confined itself to a one-dimensional benefit system (Persky, 2001:202). Although this view was accepted by many economists, Hicks and Hotelling questioned the role of economists in cost-benefit analyses. In 1949, the British economist, Dalton suggested a transfer from a rich individual to a poor one increases social welfare and ultimately vertical equity (Yitzhaki & Lewis, 1996:542). The Dalton principle proved less desirable than the Pareto principle as it did not promote the improvement of both parties concerned (Yitzhaki & Lewis, 1996:542).

Anti-utilitarian equity norms rely on factors that are weighted resulting in direct conflict with Pareto principles (Kaplou, 1995:498). Adelman and Robinson (1989:950) noted possible Pareto improvements in developing societies where the poor benefit from actual improvements in the income of the rich. Although tax policy is associated with the appropriate distribution of income, a notion not addressed by the Pareto principle, the Pareto principle could provide important implications for tax policy norms (Kaplou, 1995:498). The improvement in quality of lives of the poor due to redistribution of income can be noted as an enhancement in the lives of the poor. Utilitarianism does not include an investigation into the process of income distribution motivating tax policy makers to consider the principles of horizontal equity and rank reversals (Kaplou, 1995:507). However, inequity may arise from either an improper action or a denial of equal opportunity resulting in these issues not being addressed by equity principles (Kaplou, 1995:507–508).

The marriage between economic principles and political values does not always provide the desired results. However, cost-benefit analyses need to be addressed together with the principles of equity and efficiency with the Gini coefficient being an important component of this assessment.

#### **4.4.4 Gini Coefficient**

Income distribution is important as it provides an important departure point when determining the effectiveness of tax policy decisions and assessing vertical equity (Younger *et al.*, 1999:318). The Gini coefficient or index is a statistical measure of distribution developed by Corrado Gini in 1912. The Gini index is used as an indication of income inequality with a coefficient of 1 representing perfect inequality and an index of 0 denoting perfect equality.

Since 1994, the Gini coefficient in South Africa has increased from 0.61 in 1996 to the 2015 value of 0.63 prompting the World Bank to declare South Africa as one of the most unequal countries in the World (The World Bank/Stats SA, 2018:xv). The inequality index in South Africa is stated to be among the highest levels which is discussed further in Chapter 5.

Coupled with the analysis of efficiency and equity the concept of fairness as it relates to tax policy is important. As mentioned previously, this study sought to view equity and fairness as separate principles.

#### **4.5 Fairness**

Fairness is sometimes used interchangeably with equity as some economists regard it as the same concept. However, Varian (1973:2) stated that a minimal requirement for an allocation to

be fair is if it is both equitable and Pareto efficient. This refutes the notion that equity and fairness are identical concepts.

The principle of fairness centres on the debate of who should pay taxes, how much should be paid and why should taxes be paid (Che Azmi & Perumal, 2008:12). As simple as this may sound it further raises a host of questions relating to what should be taxed, at what rate, should there be basic allowable exemptions and the method of distribution of tax across income brackets (Alesina & Angeletos, 2003:3). To effectively assess the fairness of a tax system, the purpose and general attributes of the system need to be analysed (Duff, 2005:2). Fairness is difficult to define as it is multidimensional and needs to be compatible in the context of individuals and society at large (Che Azmi & Perumal, 2008:12). Traditionally tax systems are evaluated on the amount of revenue raised, the level of excess burden or distortion created and whether these taxes meet the accepted norms of equity and fairness (Aronson & Lambert, 1994:273). Other than its primary function of raising revenue, the levying of taxes may perform a socio-economic function with the aim of redistributing economic resources (Duff, 2005:2). The preceding discussion advocates equitable tax systems which leads to a discussion on the constitution of a fair tax share.

Tax equity is concerned with the fair treatment of individuals who have either the same or differing income levels (Infanti, 2008a:1194). Horizontal and vertical equity principles manage the equal and unequal income problem as discussed in Section 4.4. Tax fairness is calculated by the use of two methods each differing in its method of calculation. The benefits approach reflects transactional equivalence fairness while the ability-to-pay approach reflects tax fairness as equality of sacrifice (Duff, 2005:3). Tax theorists initially believed tax fairness required the tax burden to be apportioned in relation to the services received by the taxpayer (Fleming Jr *et al.*, 2001:333). Tax burden would theoretically be calculated on the value of goods and services received, an idea which proved impractical as it was impossible to formulate accurate allocations of benefits (Fleming Jr *et al.*, 2001:333). The benefits approach, as a measure of tax fairness, assumed a just distribution of economic resources may impede access to publicly provided goods and services and limit the method in which these goods and services are publicly distributed (Duff, 2008:3). As an alternative measure, the benefits approach was replaced by the ability-to-pay approach according to a taxpayer's taxable capacity (Duff, 2008:4). The 'ability-to-pay' norm with revised benefits resulted in income from international sources being taxed differently to locally earned income (Fleming Jr *et al.*, 2001:334–335).

The interpretation of this principle has been controversial as it is not certain whether the measure of welfare should be assessed at a particular point or over a period of time and it is uncertain whether the interpretation of the term 'equal sacrifice' should be calculated in terms of

subjective utility or according to each taxpayers' economic capacity (Duff, 2008:4). However, the revised benefits theory also fails the fairness test as the benefits allocation required would not be feasible (Fleming Jr *et al.*, 2001:337).

Fairness should not be evaluated in isolation or considered more important than any other factor affecting tax policy. Although the principle of fairness is a significant goal of tax policy the distinction between similar and dissimilar taxpayers (Klein, 2014:455), which is a basic requirement, proves challenging.

Equitable and fair taxation policies encourage a state of optimum taxation provided basic economic concepts are adhered to.

#### **4.5.1 Optimal Taxation**

Any economy faced with a large number of people with differing characteristics would find it difficult, on ethical grounds, to decide on the varying amounts of tax that should be administered (Atkinson & Stiglitz, 1976:56). The amount of tax paid by an individual taxpayer is determined by the taxpayer's income and the applicable tax legislation in the particular economy (McKerchar & Evans, 2009:1). If these characteristics could be observed costlessly and perfectly, the theory of optimal taxation would involve the derivation of a functional relationship between the various characteristics and the taxes that ought to be paid (Atkinson & Stiglitz, 1976:56). Unfortunately there is no perfect fit with an optimum tax structure being a greatly desired concept.

Optimal tax theory should ideally initially address questions relating to the type of tax to be implemented either income or commodity tax, and the applicable tax rates depending on the type of tax chosen (Gentry, 1999:307). Optimal taxation theory commands an equitable tax burden subject to the requirement of raising revenue with minimum tax distortions (Auerbach & Feldstein, 2002:1349). Avi-Yonah (2002:1400) in his attempt to define optimal tax theory raised the following question:

Given that income taxes generate a disincentive effect on work, what is the ideal tax and transfer system if the ultimate goal is to maximize the sum of the utilities of individuals with identical preferences?

Theoretically, optimal taxation should aim to minimize the efficiency costs of a distorted tax system (Sandmo, 2005:644) while maximizing revenue collection by the State.

Over the years numerous economists attempted to define the concept of optimal taxation. In 1920, Pigou concluded that optimal taxation is at the level where marginal taxes and subsidies

equal marginal external harms and benefits (Kaplow, 2006:1). However, this Pigouvian rule needed modification due to the interaction between environmental regulation and income taxes as the indirect effect of environmental policy on labour supply affected the need to raise revenue (Kaplow, 2006:1).

Infanti (2008a:1204) referred to optimal taxation as the economic ideal of efficiency concerned with utility and wealth maximization. Optimal taxation poses the problem of choosing a set of tax instruments that maximize social welfare while meeting government budget constraints (Sandmo, 2005:656). This implies tax revenue should be equal to government expenditure with the optimal theory aiming to achieve this status.

Modern optimal taxation theory includes all income earned by the taxpayer irrespective of the source of the income. Real taxes should be dependent on labour and capital with the relevant basis of taxation based on real capital income not nominal capital income (Mirrlees, 2010:606). However, when considering efficiency, the optimal tax mix favours a simple lump-sum income tax with no commodity taxes (Alm, 1996:119) which would result in an efficient but inequitable tax mix. When the principles of equity are considered the use of both income taxes and commodity taxes are advocated (Alm, 1996:119). Optimal tax rules must balance the equity gains of higher marginal tax rates with the efficiency losses that higher tax rates generate (Alm, 1996:120). It is apparent that optimal tax theory requires numerous assumptions relating to the distribution of the income-earning ability of society, the rate at which the marginal utility of income decreases and the effect of tax rates on labour output (Avi-Yonah, 2002:1400).

Optimal tax theory tends to reject progressive marginal rates as it is believed that higher tax rates should be prevalent at the level where the highest number of taxpayers exists consistent with the Mirrlees optimal non-linear income tax model (Avi-Yonah, 2002:1401). Avi-Yonah (2002:1401) clarified this by stating:

[o]ne of the main conclusions to be drawn from the Mirrleesian optimal non-linear income tax model is that it is difficult (if at all possible) to find a convincing argument for a progressive marginal tax rate structure throughout.

Optimal non-linear taxation theory does not adhere to the principles of equity as incentive allowances are not taxed. This can further aggravate other prerequisites for a fair tax policy such as compliance.

To summarise: Optimal taxation theory requires tax revenue and government expenditure to be equal. This theory raises numerous uncertainties relating to extravagant government expenditure, certainty of predicted tax revenue and among others the fulfilment of basic

economic principles. However, the resultant optimal tax policy may be sub-optimum but optimal for those particular circumstances.

The collection of tax revenue and the equitable implementation of tax policy unfortunately relies on factors other than those already discussed. Another important factor when considering tax reform is the level of compliance of taxpayers particularly in developing countries as this directly affects total revenue collected thereby impacting on tax equity.

#### **4.6 Compliance**

The tax burden of a country is dependent on its objectives relating to macroeconomic policy, efficiency and the need for social spending (Basilgan & Christiansen, 2014:80). The enactment of tax policy does not necessarily result in revenue being raised; it is the enforcement and administration of the published tax laws that transfer the necessary funds from individuals to government coffers (Slemrod & Yitzhaki, 1996:174). Although developed countries utilize income taxes to collect revenue, the benefit of this choice is marred by the distortion of economic activity and related administrative and compliance costs (Kaplow, 1994:1; McKerchar & Evans, 2009:1). Globally tax systems are based on voluntary compliance which is imperfect (Bishop *et al.*, 1999:2) unintentionally supporting tax evasion and/or tax avoidance.

Tax compliance is enhanced when the paying of tax is viewed as a fair fiscal exchange (Cummings *et al.*, 2009:449). Non-compliance results in horizontal inequity caused by “tax cheating” which ultimately requires reranking caused by this non-compliance (Bishop *et al.*, 1999:4). Due to the inequality created by tax non-compliance vertical equity will also be adversely affected (Alabede, 2014:39). Non-compliance affects both horizontal and vertical equity and influences efficiency affecting the tax base and ultimately tax reform principles.

Taxpayers generally utilize three activities to minimize the impact of tax: a shift to other activities; investing time and money into the analysis of legal tax avoidance and thirdly the illegal evasion of tax (Slemrod & Yitzhaki, 1996:178). Tax evasion threatens the capacity of government to raise revenue, hindering tax revenue performance and is particularly prevalent in developing countries (Basilgan & Christiansen, 2014:77; Chau & Leung, 2009:34). Widespread tax evasion creates misallocations in resource uses and reduces the governments’ ability to operate effectively and provide adequate services (Basilgan & Christiansen, 2014:77). Tax evasion influences the level of government spending and capital accumulation which ultimately affects output and economic growth. Tax avoidance, although considered as the legal escape from paying tax impacts both horizontal and vertical equity as the taxation of equals and unequals become skewed. Tax avoidance is equally harmful especially when these avoidance

theories are created by the tax laws of the country. Complicated tax structures and tax incentive allowances provide the motivation for averting tax legally (Batrancea *et al.*, 2012:14).

#### **4.6.1 Tax Compliance Models**

The concept of tax evasion posed a serious threat to tax compliance which resulted in a comprehensive review of the factors affecting tax compliance (Chau & Leung, 2009:34). The pilot study based on Becker's analysis was forwarded by Allingham and Sandmo in 1972 and examined tax behaviour (Basilgan & Christiansen, 2014:85; Leviner, 2009:392). Becker analysed the possibility that criminal behaviour was rational based on Bentham's utility theory (Leviner, 2009:390) and deduced that if the expected utility of committing a crime is greater than the utility of using time and resources in other activities then a crime will be committed. The related tax model predicted an increase in the penalty rate and the probability of detection will reduce tax evasion to a certain extent (Abrie & Doussy, 2006:2) depending on the expected utility theory (Leviner, 2009:390). Cummings *et al.* (2008:447) disputed the suggestion of increasing penalties and the frequency of audits, concluding that this may encourage bribery and corruption resulting in lower tax compliance and loss of trust in public institutions. The Allingham-Sandmo economic deterrence model was expanded on by various economists to include income and substitution effects (Basilgan & Christiansen, 2014:85).

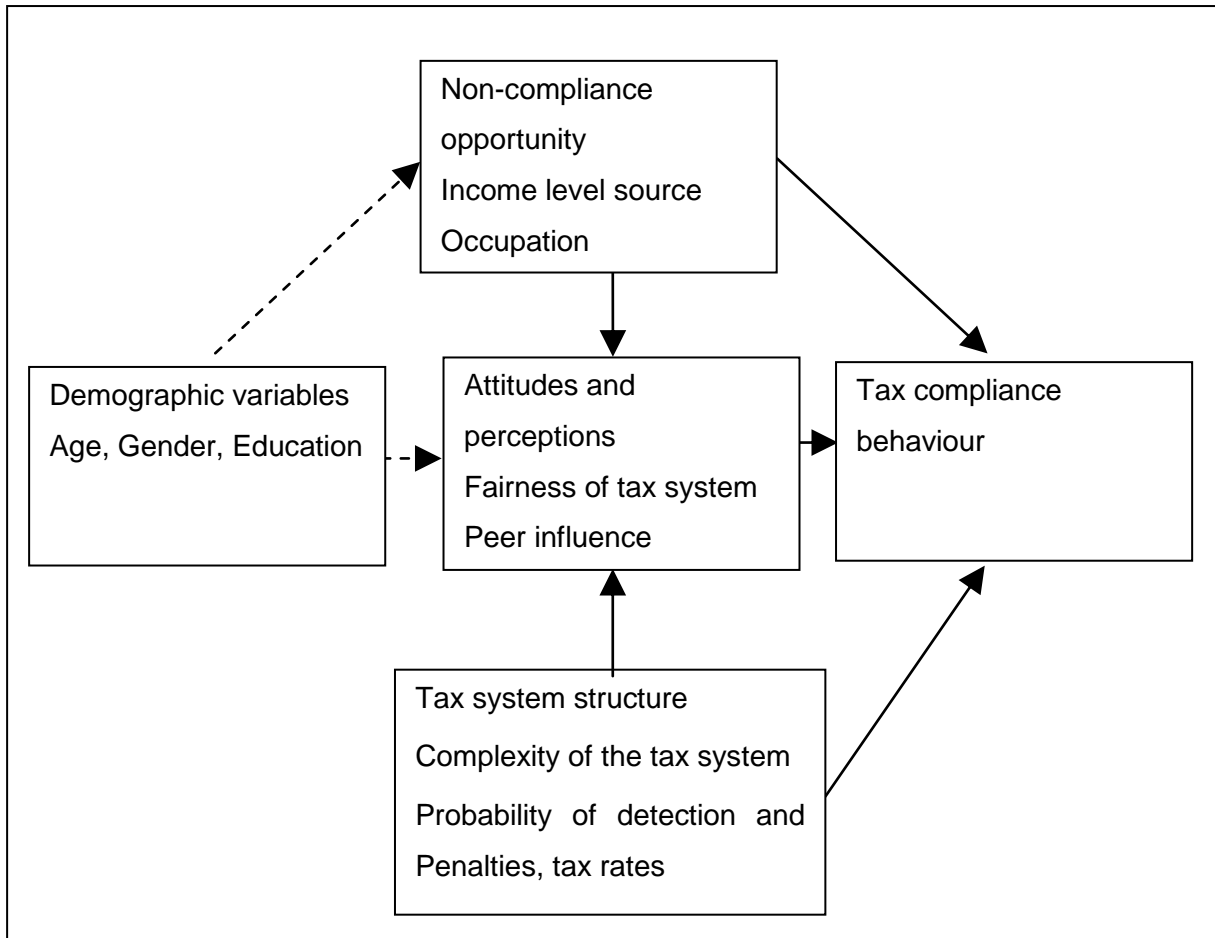
Yitzhaki (1974) found an increase in tax rates usually resulted in an increase in tax evasion whereas low income decreased the tendency to evade tax (Basilgan & Christiansen, 2014:85). Low income earners do not have the capacity to evade tax whereas higher income earners are more affluent and knowledgeable regarding changes in tax policy. However, the models concluded tax evasion was rife either due to the methods of collections being inadequate or the belief that the government was not entitled to the money (McGee, 2014:380). In 1944, a Catholic priest, Crowe, reviewed 500 years of philosophical literature and identified reasons for the justification of tax evasion. The reasons included tax rates being too high and tax system considered unfair, corruption in government departments with wastage of tax funds, no benefits being received and the inability of taxpayers to pay tax (McGee, 2014:380). However, tax evasion is not restricted to economic factors and also incorporates social psychological factors.

"As economists become more sophisticated, their ability to incorporate their findings of other disciplines such as psychology improves" (Thaler, 2000:140). He also highlighted the positive effects of a model involving both economic and behavioural perceptions. Behavioural economics, a subsection of economics, identifies the ways in which behaviour differs from normal and studies the reactions to these as related to economic principles (Mullainathan & Thaler, 2000:2). In 1992 the Fischer Model (Figure 4-2) was released which characterised the

14 factors related to tax compliance into four groups (Chau & Leung, 2009:34). This model, unlike previous models, incorporated both economic and psychological factors. The first group related to demographics which incorporated age, gender and education while the second group dealt with non-compliance opportunities such as income levels, income source and occupation (Chau & Leung, 2009:34). The third group included attitudes and perceptions towards tax and the last group analysed the complexity of the tax system, tax rates and the possibility of penalties being raised (Chau & Leung, 2009:35). With the analysis of these four groups, this model incorporated economic, sociological and psychological factors (Chau & Leung, 2009:35). As illustrated in Figure 4-2 (below) taxpayer compliance behaviour is indirectly influenced by demographic factors and tax legislation that affects both attitudes and perceptions of taxpayers and non-compliance prospects. Compliance behaviour is directly influenced by any opportunity to be non-compliant and attitudes and perceptions.

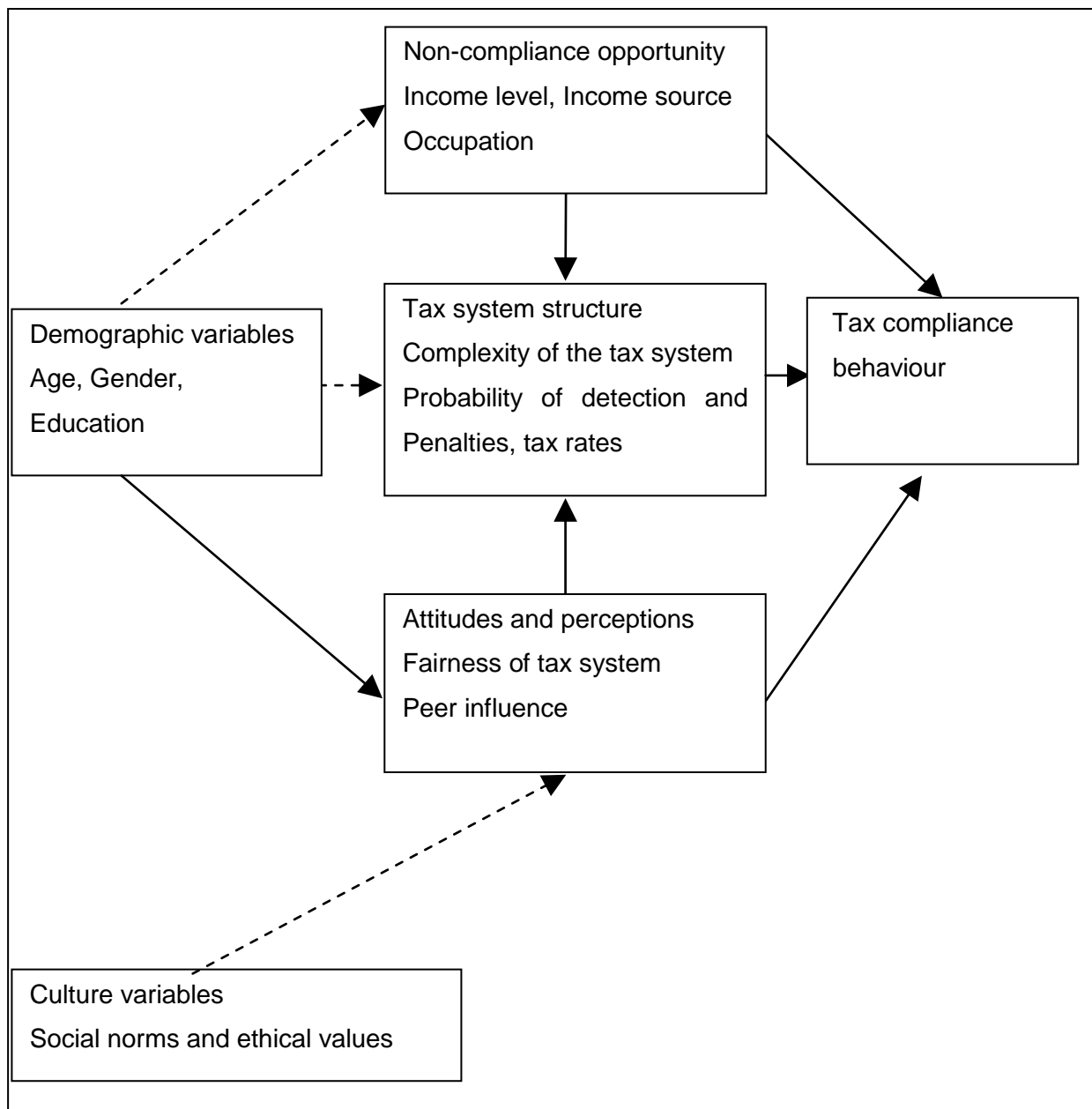
Tax system structure, non-compliance opportunity and attitudes and perceptions have a direct effect on taxpayer compliance while the demographic factors have an indirect influence (Alabede *et al.*, 2011:110). Tax system structure has been found to be a major factor in determining the degree of tax compliance with its effectiveness being influenced by tax rates and the complexity of the tax system, penalties levied and the probability of detection (Alabede *et al.*, 2011:110). Experimental research found tax compliance improved if taxpayers observe a direct relationship between taxes paid and public utility gained (Schnellenbach, 2006:3). Tax morale, which can be interpreted as “an intrinsic motivation to pay taxes” (Feld & Tyran, 2002:197) appears to greatly influence the compliance levels of individuals. Schnellenbach (2002:18) indicated that tax morale was a factor that could affect compliance negatively resulting in tax evasion.

Chau and Leung(2009) although agreeing with the basic Fischer tax compliance model forwarded a modified Fischer tax compliance model (Figure 4-3) where compliance was shown to be directly and indirectly related to non-compliance opportunities, attitudes and perceptions relating to tax and tax legislation. A further variable relating to cultural norms and ethics was introduced enhancing non-compliant behaviour among taxpayers.



**Figure 4 - 2: Fisher et al (1992) tax compliance model**

(in Chau & Leung, 2009:38).



**Figure 4 - 3: Modified Fisher tax compliance model**

(in Chau & Leung, 2009:38)

Although compliance related issues focussed on the taxpayer only, Kirchler *et al.* (2012:7) emphasised a modern view of taxpayer compliance other than the taxpayer behaviour that was portrayed as “rational, outcome-oriented, self-controlled, selfish, and egoistic individuals who strive to maximize their own gains.” As a large number of taxpayers understand and acknowledge the need for the levying of taxes, they respond favourably with greater awareness and clarity of the tax system (Kirchler *et al.*, 2012:7).

Unfortunately taxpayer behaviour is also affected by taxpayers' attitudes and perceptions towards the State, government and levels of corruption including psychological factors that influence tax morale which could result in tax evasion (McKerchar & Evans, 2009:1). Another important factor affecting compliance currently is the political situation some countries find themselves in. Non-compliance by taxpayers results in reduced tax revenue in the State coffers due to tax avoidance and evasion.

#### **4.6.2 Tax Avoidance and Evasion**

Tax evasion can be defined as the illegal avoidance of tax by either non-disclosure of income or operating in an economy that is not legal (Martinez - Vazquez & Alm, 2003:146; Sandmo, 2005:644) while tax avoidance is the manipulation of the taxpayer's affairs to limit or reduce tax payable within legal boundaries (Sandmo, 2005:644). The tax evasion problem is significant in developing economies as citizens tend to operate outside the legal economic area to escape the tax net (McKerchar & Evans, 2009:1). This effectively reduces the actual tax base and ultimately the revenue collected by the State.

Abu Bakar and Abdur Rahman (2007:31) believed:

Tax avoidance basically means playing with the tax rules, and it is regarded as a legal activity, provided it falls within the rules and regulations. Its legality is based on the idea that every taxpayer has the right not to attract tax and to arrange his tax affair.

Abu Bakar and Abdur Rahman (2007:31) further defined tax evasion techniques as:

suppressing the taxable receipts; and claiming deductions for expenditure not incurred. Evading payment of tax due by any person involves elements of offence in it. If caught, the defaulter has to pay the tax evaded and penalties

Tax avoidance is perpetrated by postponement of taxes, tax arbitrage across individuals facing different tax brackets or across different income streams or a combination of all three factors (Stiglitz, 1986:3) with tax arbitrage being defined as an activity that takes advantage of the inconsistencies in tax law that feature economically offsetting positions which result in asymmetric tax treatments (Slemrod & Yitzhaki, 2002:1444).

Slemrod and Yitzhaki (2002:1438–1439) resolved the measurement of tax evasion presented two problems, one conceptual and the other empirical. Although legality is the dividing line between evasion and avoidance theoretically, practically the division is blurred. Legality of certain sections can be interpreted differently depending on individual analysis resulting in indistinct conclusions. The other difficulty is the actual measurement of tax evasion as

information is not freely available and very unlikely to be revealed by the evaders as individuals possess strong incentives to conceal their financial affairs (ACCA, 2017:7). A further problem is the lack of reliable information on tax compliance (Alm, 2012) but as Cowell (1990) (cited in Cummings *et al.*, 2008:447) noted:

the issue of evasion is, unlike other illegal activities, inseparably bound up with the instruments of fiscal control that the government attempts to use in carrying out its economic policy.

Tax evasion and avoidance may result in understated income on tax returns resulting in income distribution inequality. Certain challenges arise from these problems particularly when affluent taxpayers employ the ease of international capital mobility as an additional form of tax evasion (McKerchar & Evans, 2009:3). Developing countries tend to tax capital income and wealth encouraging taxpayers to move their funds to more favourable tax jurisdictions (Giovannini, 1987:2). This understatement of income will affect progressivity of tax and ultimately vertical equity principles (Alm, 2012:18) while horizontal equity meant to be altered by the non-compliance of certain individuals. Capital mobility further affects the total tax revenue collected resulting in suboptimal collections further affecting equity (Alm, 2012:20–21).

Higher tax revenues would further result in more favourable equity measures being achieved. Various experimental studies relating to the level of tax evasion have shown the magnitude of tax evasion to be proportional to the satisfaction of the taxpayer with the tax system, tax rates and tax administration (Schnellenbach, 2006:2). Tax evasion studies do not lend themselves easily to measurement which can affect collection of tax revenue and have serious equity implications (Alm, 2012:2). Non-compliance similarly leads to an underground or shadow economy which is extremely difficult to measure but is believed to be higher in developing countries (ACCA, 2017:7). As economic policy decisions including tax reform policy are created on the revenue and expenditure statistics available to policymakers, a high tax non-compliance rate with a large shadow economy will affect future policy declarations (D'Hernoncourt & Méon, 2011:1). These changes have an adverse effect on equity, efficiency and fairness resulting in the shadow economy playing an important role in this study.

#### **4.6.3 Shadow Economy**

The causes of the shadow economy are dominated by two schools of thought. The first school of thought believes high tax and social security burdens result in potential taxpayers being driven out of the official economy (D'Hernoncourt & Méon, 2011:2) while the second school of

thought believes institutional quality, that is regulatory discretion, bureaucracy, corruption and an ineffective legal system can drive economic agents underground (Dreher *et al.*, 2005).

This leads to the invaluable discussion of whether compliance, tax evasion and the shadow economy are related. D'Hernoncourt and Méon (2011:2) believed the concept of the shadow economy is more complex than either compliance or tax evasion analysis. Eilat and Zinnes (2000:13) indicated that firms who enter the shadow economy to evade taxes lose their official channels of financing, reduce the capital intensity of production and operate within shorter time-frames. This results in adverse long-run economic growth which can be linked to poor tax administration providing a comprehensive view of the shadow economy challenge (Eilat & Zinnes, 2000:13). There is much debate regarding the relationship between corruption and the shadow economy as Rose-Ackerman (1999:21) noted "going underground is a substitute for bribery, although sometimes firms bribe officials in order to avoid official taxes".

#### **4.6.3.1 Definition of the Shadow Economy**

Effective and efficient decision making depends on reliable information relating to the extent and magnitude of the shadow economy. The main effects of the shadow economy include reduction in government revenue collections and distortion of official statistics influencing public sector decisions (Dell'Anno *et al.*, 2007:199). Although a difficult concept to define Schneider and Enste (2000:78) proposed the following comprehensive definition of the shadow economy:

all economic activities that contribute to the officially calculated (or observed) gross national product but are currently unregistered.

Choi and Thum (2003:2) defined the shadow economy as "the unofficial economy constitutes activities that are not recorded in government statistics". However, the shadow economy as per Figure 4-4 (Table 1) below includes unreported income from legal activities, which would be taxed normally if reported to the relevant tax authorities as well as illegal activities. The growth of non-reported legal activities has notably increased especially in recessionary times (Hassan & Schneider, 2016:2).

	Monetary Transactions		Nonmonetary Transactions	
Illegal Activities	Trade in stolen goods; drug dealing and manufacturing; prostitution; gambling; smuggling and fraud.		Barter: drugs, stolen goods, smuggling, etc. Produce or growing drugs for own use. Theft for own use.	
	Tax Evasion	Tax Avoidance	Tax Evasion	Tax Avoidance
Legal Activities	Unreported income from self-employment; Wages, salaries and assets from unreported work related to legal services and goods	Employee discounts, fringe benefits	Barter of legal services and goods	All do-it-yourself work and neighbor help

*Source:* Rolf Mirus and Roger S. Smith (1997, p. 5), with additional remarks.

**Figure 4 - 4: A Taxonomy of Underground Economic Activities.**

(Source: Schneider & Enste, 2000:79.)

Schneider and Enste (2000:70) highlighted an important phenomenon of the shadow economy in that it develops continuously “like the principle of running water” depending on adjustments to the tax system. The definition of the shadow economy may vary depending on the chosen method of measurement in a particular jurisdiction, the most common being the measurement of:

legal value-added creating activities which are not taxed or registered and where the largest part can be classified as “black” or clandestine labour”

(ACCA, 2017:7; Schneider & Enste, 2000:79).

Chaudari *et al.* (2006:428) further defined the shadow economy as an economy that “consists of legal and illegal activities outside the reach of government”. Schneider (2010:442) ultimately offered the broadest definition of the shadow economy “those economic activities and the income derived from them that circumvent or otherwise avoid government regulation, taxation or observation”.

#### **4.6.3.2 Factors Influencing the Shadow Economy**

The growth of the shadow economy can be attributed to economic, sociological and psychological factors (McKerchar & Evans, 2009:1; Schneider & Enste, 2000:82). These include a rise in the burden of tax rates and regulations, perceived fairness of tax systems, early retirement, and unemployment and tax morale. Torgler and Schneider (2007:3) stressed the

importance of analysing both the objective factors such as tax burden, extent of public expenditure, or the extent of regulation and subjective perceptions such as expectations, attitudes towards tax and tax morale. Tax morale is defined as the intrinsic motivation to pay taxes with the belief that paying taxes contributes to society (Torgler & Schneider, 2007:12). However, it is important to note this is not an objective definition and is subject to bias. This measurement does provide a more sensitive method of obtaining tax evasion statistics but is subject to the taxpayer reporting higher tax morale than is factual (Torgler & Schneider, 2007:14). Tax morale is often incorrectly linked to tax compliance. Tax morale is a moral attitude while tax compliance is tangible behaviour by the taxpayer (Kirshgassner, 2010:2).

Giles and Tedds (2002:7 cited in Davis & Henrekson, 2004:5) established;

Perhaps the single most commonly cited 'driving force' of the underground economy is the actual, or perceived, tax burden."

This view was first established by Schneider (2002:2) where he stated in all studies the most important cause of an increase in the shadow economy was an increased tax burden which resulted in tax erosion. These studies suggest the importance of affordable tax rates where taxpayers perceive that they are being treated fairly and receiving value for their money (ACCA, 2017:7; McKerchar & Evans, 2009:1). Eilat and Zinnes (2000:14) highlighted the importance of institutional characteristics such as administrative efficiency, extent of control held by politicians and bureaucrats, and bribery and corruption as additional influences when considering the shadow economy.

#### **4.6.3.3 Effects of the Shadow Economy**

A growing shadow economy results in inaccurate official indicators of unemployment, income, official labour force and consumption resulting in questionable intended policy measures (Schneider, 2002:2). Kearney and Schneider (2013:4) examined the size of the shadow economy in Europe from 2003 to 2013 and noted the effects of economic cycles on the shadow economy. The size of the shadow economy, measured as a percentage of gross domestic product, increased during periods of rising unemployment, economic downturns and fears relating to future economic activities (Kearney & Schneider, 2013:4). Measurement of the shadow economy can be performed either directly using micro-surveys and tax audits or indirectly investigating currency demands, the transaction approach (assumes a constant relationship between volume of transactions and official gross national product), and total electricity usage versus total household electricity usage (Eilat & Zinnes, 2000:19–20;

Schneider & Enste, 2000:91–98). Although statistical methods have been adopted no method is fool-proof as the concept being dealt with is largely illegal.

Dell'Anno (2006:254) proceeded to highlight both the negative and the positive effects of the shadow economy adding that two-thirds of the income earned in the shadow economy is immediately spent in the official economy creating a positive effect on the official economy. Underground activities may add a dynamic element to the economy, increasing competition in some sectors and may improve the distribution of income (Dell'Anno, 2006:254). The shadow economy could act as a temporary lever for promoting business activities in jurisdictions with burdensome regulatory measures and increased levels of government corruption (Eilat & Zinnes, 2000:10). These effects should be considered when planning economic policies. However, the underground economy does not relieve the tax burden on citizens who choose to be part of the legitimate economy. Gathering statistics relating to the size and structure of the shadow economy, its frequency and magnitude has become fundamental to effective, efficient (Schneider, 2005:113) and equitable tax policy decisions.

#### **4.6.3.4 Overview of the Shadow Economy**

The concept of the shadow economy includes undeclared, under-declared, non-measured and under-registered transactions executed to avoid the burden of tax and circumvent regulatory restrictions (Ahumada *et al.*, 2007:363). The shadow economy can be divided into three distinct categories: pure tax evasion where legal activities are performed legally without the payment of mandatory taxes; the hidden or black economy where legal activities are performed illegally resulting in tax evasion and criminal activities where illegal activities are performed illegally resulting in tax evasion (Kirshgassner, 2010:1).

Attempts at calculating the shadow economy resulted in different methods being advanced by economists over the past forty years. However, as this represents the hidden, underground, unrecorded economy accurate results cannot be obtained irrespective of whichever method is employed. Statistics predict shadow economies range from 12 percent of GDP in OECD countries to 76 percent of GDP in developing countries (Schneider & Enste, 2000:100). Attempts to control the shadow economy include punishment, prosecution, economic growth and education (Schneider, 2005:113).

There are, however, certain precautionary measures that can be employed to reduce the impact of the shadow economy. Increasing the efficiency of tax auditing coupled with simplification of the tax system could improve perceptions and tax morale (Schneider, 2002:26). This would encourage compliance resulting in an increase in tax revenue and a decreased tax burden for

all citizens. The tax burden would be uniformly distributed improving equity, both horizontal and vertical, among taxpayers.

Economic and non-economic factors relating to tax have been discussed in the chapter. Of primary concern was equity which is influenced by various other factors and it is believed mention of tax incidence would also prove useful in determining the effects of tax policy decisions which can ultimately be altered to ensure equity and efficiency in future tax reform policies. A brief overview of the importance of tax incidence follows.

#### **4.7 Tax Incidence**

Tax incidence is broadly defined as “the study of the effects of tax policies on the distribution of economic welfare” or simply described as who bears the economic burden of taxes (Fullerton & Metcalf, 2002; Kotlikoff & Summers, 1987; Slemrod & Yitzhaki, 2002). Tax incidence is the analysis of the impact of taxes on the distribution of welfare within a society (Fullerton & Metcalf, 2002:1790). Of concern to policy makers is the distinction between statutory incidence i.e. the legal payers of tax and the economic incidence i.e. those who actually lose income (Fullerton & Metcalf, 2002:1791). Tax policy decisions should be based on the effects of alternative tax measures on economic equilibrium concentrating on the distribution of economic welfare (Kotlikoff & Summers, 1987:1043). Economists concentrated on economic incidence which measured the changes in economic welfare that resulted from the levying of a particular tax (Fullerton & Metcalf, 2002). Economic incidence studied the change in behaviour with the resultant change in equilibrium prices as consumers utilized less of the taxed products resulting in reduced production affecting all members of society (Fullerton & Metcalf, 2002).

A number of tax incidence studies have been concluded by developing countries concerned over the equity of their tax policies (Shah & Whalley, 1991:537). However, the bases used were identical to those used by developed countries resulting in erroneous conclusions being reached (Younger *et al.*, 1999:313). As developing countries are not homogeneous no single uniform basis of determining tax incidence would be appropriate. Certain important factors need to be considered when analysing tax incidence: international trade taxes, local coverage of income tax, the incidence of tax evasion and the existence of a black or informal market economy (Shah & Whalley, 1991:540). Non-tax incidental factors that affect incidence data include urban-rural migration, product market competition, price controls, industry concentration and the presence of unions may alter the incidence analysis (Shah & Whalley, 1991:540). Most developing countries provide unreliable data on the distribution of income, consumption models and the allocation of tax revenues by income-class making tax incidence studies rather unreliable (Bird & De Wulf, 1973:646).

Tax incidence studies should be performed on all taxes to determine the real allocation and the real burden on individual taxpayers, with the relative tax burden being compared using the ratio of economic burden to income (Fullerton & Metcalf, 2002:1791).

In an effort to ensure equity, efficiency and fairness trustworthy tax incidence statistics are imperative when reviewing tax reform policy modifications to ensure the correct distribution of income particularly in developing countries.

#### **4.8 Conclusion**

Equity, efficiency and fairness form the building blocks of tax legislation as has been shown with the ability-to-pay and benefit principles becoming synonymous with tax policy and reform implementation.

Income tax has, over the ages, transformed into the largest revenue producing instrument having adapted to structural changes in international trade and finance, economic and institutional development, political and cultural changes, different fiscal policy models and technological advancement in administration (Barreix & Roca, 2007:121). The principles of economic efficiency (Section 4.3) have enabled the progress of revenue collection. Efficiency, a newcomer to the economic field, assists in the enactment of taxes that minimize deadweight loss and aid in the debate surrounding the definition of income.

Equity (Section 4.4), a raging debate among economists to this day, is important in assessing the fairness (Section 4.5) of the tax system irrespective of the definitions employed. Whether horizontal equity or vertical equity is considered more important, tax systems need to be designed to broaden the tax base to ensure adequate collection of revenue while maintaining basic equity considerations.

Analysis of any tax base requires the need for future tax changes and the associated transition issues (Mirrlees, 2010:605). These changes need to adhere to the equity principles and ensure efficiency of the tax amendments. Although transition issues can be calculated from past and present tax changes, future changes are endogenous to the policy framework created (Mirrlees, 2010:605). Taxes change due to changes in governments and revisions of revenue requirements (Mirrlees, 2010:605). However, the frequency of changes can be adjusted with tax regulations having a 'sunset clause' that is a time limit for their effectiveness (Mirrlees, 2010:605). Tax reform is, however, inevitable as the demands required of public revenue are continually being altered.

Developing countries with their limited administrative capacities, high levels of informal trade (Section 4.5.4 and 4.6) and predominantly agricultural sectors encounter unique difficulties when designing tax systems. The nature and size of governments and the relative use of various tax instruments play an important role when designing a tax system (Sokoloff & Zolt, 2007:131). In these countries the overwhelming need to raise as much revenue as possible and to redistribute income and wealth cannot be disregarded (Bird, 2003:11). Tax policy is as much political as it is economic, however, political ideals should not dominate (Bird, 2003:15). Tax policy should focus on the real conditions prevalent in a particular state and the relevant economic concepts. Although optimal tax (Section 4.5.1) reforms focus on aspiring to attain the most efficient tax structure, the objective of uniform taxation lies in improving the efficiency of taxation (Thirsk, 1991:58). Should tax policy be based on achieving broader-based taxation at uniform rates or should it be based on the principles of efficiency and equity related to the optimal taxation theory? The answer to this lies, unfortunately, not in economic theory but is very often a political decision depending on the number of votes a particular political sect can garner.

Democratization has led to changes in certain types of government programs; however it is still difficult to design a purely progressive tax system as advocated by the rules of vertical equity in a society riddled with gross income inequalities. Tax policy should be a balancing act designed around the concepts of efficiency, equity and fairness (Sections 4.3; 4.4 and 4.5). Tax reform proposals in developing countries strive to achieve the objectives of economic neutrality, horizontal equity and tax simplification (Thirsk, 1991:58). Macroeconomic imbalances associated with tax policy cannot be judged in advance making it impossible to avoid some sort of risk (Khalilzadeh-Shirazi & Shah, 1991:252). However, close surveillance of the risks and the correction of what does not work, although gradual, is effective tax policy in developing countries (Khalilzadeh-Shirazi & Shah, 1991:252).

In the words of Schumpeter (1954:7 cited in Khalilzadeh-Shirazi & Shah, 1991:252):

The spirit of the people, its cultural level, its social structure, the deeds its policy may prepare, all this and more is written in its fiscal history, stripped of all phrases. He who knows how to listen to its messages here discerns the thunder of world history more clearly than anywhere else.

An analysis of the South African tax system and its adherence to the basic economic principles follow. A review of the South African Income Tax Act 58 of 1962 (as amended) will be considered, the official national statistics relating to tax revenue collection, particularly personal

income tax, will be reviewed including the various tax commissions since and their deliberations.

## **CHAPTER FIVE:**

### **TAX POLICY AND LEGISLATION IN SOUTH AFRICA**

#### **5.1 Introduction**

Chapter 3 emphasized the importance of economically acceptable taxation practices historically while Chapter 4 expanded on the principles of equity and its associated issues. Related economic and non-economic factors affecting tax legislation were also examined and the necessity of implementing optimal tax legislation highlighted. An overview of tax policy and legislation in South Africa is discussed in this chapter as policy recommendations are ineffective if not promulgated into law.

Although taxation is regarded as a fundamental tool used by decision makers keen to direct the use of scarce resources for public consumption in a democracy, it performs an essential function in the economic cycle which must moreover be effective in its collection mechanism (Carnahan, 2015:169; Tanzi & Zee, 2000:299). African governments need to establish stable and predictable fiscal environments that stimulate economic growth and investment while maintaining good governance and accountability between the government and its citizens (Carnahan, 2015:168; Harelimana, 2018:28) to establish a workable fiscal-social contract (Forstater, 2018:5). The growing tax burden for these developing countries due to extensive levels of unemployment and poor economic growth with the absence of fiscal consistency began to initiate the trend where taxpayers sought to either evade or avoid taxation (Tanzi, 2006:12). However, the public consumption of goods and services requires a functioning, accountable and legitimate state to effect the role of revenue-collection (Carnahan, 2015:170). African countries are deprived of efficient revenue collection skills due to the lack of confidence in the rule of law by the citizens resulting in tax evasion (Harelimana, 2018:28) Tanzi and Zee (2000:300) earlier established the effective control of an efficient tax system in a developing country is challenging due to characteristics peculiar to these countries particularly large informal trading activities. As with most developing countries, South Africa needs to ensure safety and security to encourage investment, functioning regulatory systems to enhance business expansion, effective transport, communications and energy infrastructure to promote growth, access to health and education to ensure a productive workforce and a social safety net to assist in risk-taking, innovation and labour mobility (Carnahan, 2015:169; Forstater, 2018:4). Tax policy and legislation forms a major portion of these goals as a well-functioning revenue system enables sturdy, sustained economic growth that reinforces an effective, accountable and stable government (Carnahan, 2015:169; Harelimana, 2018:28). Although tax is a self-determining issue, the effects of globalisation must be respected as international cooperation on

tax issues is much sought after (Forstater, 2018:4) and can impact South African tax legislation either adversely or favourably. In general, tax systems should be transparent, simple, effective and efficient while developing a legitimate social contract between the government and its citizens (Forstater, 2018:8) to reduce any possibility of tax evasion. Forstater( 2018:10) highlighted the purpose of tax reform is the ability to collect sufficient tax revenues while retaining an appealing investment climate to facilitate economic growth and expand the tax base.

The current South African tax system, as described by the Davis Committee (2016:6), appears to be an assortment of diverse regulations that have undergone drastic piecemeal amendments predominantly since 1994 when South Africa became a truly democratic state. The Income Tax Act No. 58 of 1962, the statutory legislation governing income tax in South Africa, has undergone drastic modifications since 1962 when it was initially implemented. Piecemeal amendments result in complex, unstable and fiscally incoherent tax systems with citizens perceiving this to be unfair resulting in this being the major influencing factor towards the attitude of citizens (Tanzi, 2006:13). The culture of tax compliance needs to be improved by designing a tax system and educating taxpayers to prevent base erosion and profit shifting (Carnahan, 2015:176–177).

Although the increased revenue demands and the rising expenditure needs of the country have impacted all taxpayers, these factors have had serious and profound effects on personal income tax legislation resulting in increases in the tax rate applicable for individuals (Tanzi & Zee, 2000:307). This phenomenon relating to personal income is reflected in the revenue statistics which will be analysed later in this chapter (National Treasury and South African Revenue Service, 2017:2). The domestic personal tax base in South Africa forms the largest revenue contributor but the unused tax potential needs to be addressed to enhance revenue collection and develop a favourable social contract between the government and the citizens.

This chapter will analyse the current tax legislation in South Africa concentrating on personal income tax, interpret the equity status of personal income tax and suggest possible tax reform methods that are adopted globally and within the Sub-Saharan African region consistent with Objective three in Chapter One.

## **5.2 Background to tax policy in South Africa**

Three different provisions control the imposition of taxes and the expenditure of said revenue namely constitutional, parliamentary and judicial provisions (Bird, 2008:2; Fichtner & Feldman, 2013:5). These provide the background for the functions associated with the implementation,

collection and expenditure of tax revenue. The legislative function of imposing taxes and enacting expenditure outflows are separated from the executive function of collecting taxes and from the judicial function of mediating disputes even though there may be overlap of functions (The Davis Tax Committee, 2017:6). In South Africa the South African Revenue Service (SARS), an autonomous tax regulator was formed to administer all tax client services including the collection of tax (Manuel, 2002:3). Although SARS has been quite successful in their efforts relating to tax collections (National Treasury and South African Revenue Service, 2017:2), an inherently unfair system cannot be as prosperous as a tax system that is deemed to be fair (Maroun *et al.*, 2011:436).

Since 1994, the formalised process of tax reform particularly personal income tax underwent various transformations partly due to the recommendation of the Katz Commission reports (Joint Standing Committee on Finance, 1996:2; Manuel, 2002:1; Steenekamp, 2012:43). Previous administrations also implemented tax reform policy on an ad hoc basis but this study will concentrate on tax reform from 1994. Government policy required an overhaul of fiscal policy, of which tax is the most influential component (Joint Standing Committee on Finance, 1996:2). Among other issues, progressive tax brackets were reduced from ten to six, the child rebate was eliminated and a primary rebate introduced which was increased annually to retain progressivity for individuals (Manuel, 2002:4; Steenekamp, 2012:43). The elimination of the taxation of married couples as one unit (Coetzee, 1995:4) was also effected during this period. Further tax reform during those years included corporate tax rates being reduced to a flat rate of 28 percent in 2013 (Gordhan, 2012:15) and the revision of value-added tax initially to its current 15 percent (Gigaba, 2018:11).

Tanzi (2004:534) described value-added tax and personal income tax as the 'workhorses' of the South African tax system. Value-added tax is levied at a fixed rate of either 0 percent or 15 percent depending on the good or service. Although value added tax was introduced in 1991 it is considered to be "an efficient revenue 'milch cow'" albeit "regressive" while personal income tax serves to raise sufficient revenue despite the requirement of it fulfilling equity demands (Steenekamp, 2012:40). Equity challenges faced by tax policies include ensuring the perception of fairness among the citizens (Maroun *et al.*, 2011:438) to ensure maximum revenue collection.

As this study is limited to the equity principles relating to personal income tax in the Income Tax Act 58 of 1962 it should be noted that the First Macro Analysis of the The Davis Tax Committee (2014:8) stressed the link between taxation and economic policy with political culture playing an important role. Economic and political culture dictates the advancement of an income tax system that is perceived as being fair. Maroun *et al.* (2011:436) echoed the sentiments of

various economists (Bird & Wilkie, 2012:5; Vivian, 2006:83–85) highlighting the four attributes that contribute to an 'unfair' tax system.

- Firstly, tax cannot be levied on both income and capital as it results in double taxation eroding the taxpayer's ability to generate further income
- Tax should be levied on the amounts earned under the protection of the State recommending a source-based taxation rather than the present residence-based system.
- The ability-to-pay should equate to the ability to bear the burden of tax and
- Finally a progressive tax system remains less attractive than a proportional tax system

(Maroun *et al.*, 2011:436; Vivian, 2006:83–85).

Taxes can create distortions, misallocation of resources and generate deadweight losses due to either the tax rate or the tax structure (Arnold, 2008:5; Fichtner & Feldman, 2013:11). Presently, the normal tax structure in South Africa levies a progressive rate for natural persons while levying a flat rate for corporate entities. Exemptions, exclusions and special deductions usually associated with a progressive tax system (Hungerford, 2006:2) are prevalent in the taxation of both corporate establishments and personal income tax. Individual taxpayers receive rebates, credits and exemptions with a limited exemption for interest earned while being taxed at a progressive rate. These special allowances, exemptions and exclusions have existed since the first modern income taxes were first implemented in 1913 (Fichtner & Feldman, 2013:11; Hungerford, 2006:2). These special allowances/privileges also referred to as tax expenditures (Hungerford, 2006:3) tend to lower the tax liability of certain taxpayers which could result in inequity, inefficiency and unfairness. Hungerford (2006:2) and Fichtner and Feldman (2013:11) agreed these tax expenditures disproportionately benefit more affluent taxpayers.

Tax, in the South African context, is levied on taxable income rather than on gross income earned. A review of gross income and taxable income, as per the Income Tax Act (No. 58 of 1962)(as amended) follows.

### **5.3 Gross income versus taxable income**

Although the economic definition of income may differ from the tax definition of income, economic principles play a significant role in the determination of income. Rosen (2008:378) believed the starting point for the analysis and interpretation of a tax system is the definition of income.:

Income is the money value of the net increase in an individual's power to consume during a period. This is equal to the actual amount during the period plus net additions to wealth. Net additions to wealth—savings—must be included in income because they represent an increase in potential consumption. (Rosen, 2008:378)

Total income as defined in the Income Tax Act No. 58 of 1962 (Income Tax Act) is termed "gross income" while taxable income is the amount on which tax is levied at the relevant tax rate which differs from gross income (SAICA, 2019:35). Gross income less tax expenditures (including exempt income (section 10 and all other deductions housed in Sections 11 to 18 of the Income Tax Act (No. 58 of 1962)) is referred to as taxable income.

Gross income is defined in Section 1 of the Income Tax Act (No. 58 of 1962) as:

in relation to any year or period of assessment, means-

in the case of any resident the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or

in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

during such year or period of assessment, excluding receipts or accruals of a capital nature,

(SAICA, 2019:15)

The above definition ensures the inclusion of all income earned by any resident; individual or otherwise, into gross income while safeguarding the inclusion of all South African sourced income into gross income of non-residents (Manuel, 2002:6). The impact of the definition of gross income results in the consistent treatment of the inclusion of income for all taxpayers irrespective of their status. This uniform management of income serves to satisfy the economic requirements of equity as discussed in Section 4.4. Horizontal equity requires the equal treatment of equals, which is fulfilled by this definition and vertical equity serves to assess the impact of taxation among unequals (see Chapter 4 section 4.4). The practice of including worldwide income of all resident taxpayers and South African income of non-resident taxpayers also fulfils the fairness requirement (see Section 4.5). This definition of income is consistent with a variation of the Haig-Simons definition where all sources of income are initially included regardless of consumption. Although the definition of income does not specifically include capital, Section 26A of the Income Tax Act includes any taxable capital gain earned during the year of assessment. The inclusion of capital gains is not included in the scope of this study (SAICA, 2019:191).

The definition of gross income is particularly important as it forms the foundation on which tax is calculated and affects future tax policy reform measures. Section 4.3.3 discussed the economic concept pertaining to the definition of income and the differing views related to the inclusions in income. The definition of gross income in the Income Tax Act (No. 58 of 1962) follows the Haig-Simons model as it includes all income earned during a particular year irrespective of source but excludes capital income. The Haig-Simons definition of income further provides for special personal deductions with a progressive tax system consistent with the principles of horizontal and vertical equity (see Section 4.3.3).

However, Gray (1989:17) cautioned on the adoption of incentive allowances by expressing the carefulness with which deductible expenses should be levied when the tax reform goal of broadening the tax base is exercised. The next paragraph will address the tax implications of deductions and allowances or otherwise termed tax expenditure.

### **5.3.1 Tax Expenditure**

Sections 10 to 24 of the Income Tax Act (No. 58 of 1962) provides for tax expenditure to be deducted from gross income. The treatment of allowances and deductions, however, varies depending on the taxpayer status which may be perceived as preferential treatment towards certain taxpayers. Tax expenditure has become a controversial international topic with the Congressional Budget and Impoundment Act of 1974 (cited in Hall, 1999:2) of the United States of America defining tax expenditure as:

those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.

while Barrios *et al.* (2016:2) described tax expenditure as:

preferential tax treatments granted to specific individuals or categories of households which aim at achieving social and economic goals – poverty fighting, inequality reduction, and employment promotion, among others.

This definition of tax expenditure compares with the sections of the Income Tax Act dedicated to the general deduction formula, special deductions, exemptions and exclusions where tax expenditure is limited to certain taxpayer types to the exclusion of others. Manuel (2002:8) defended the use of tax expenditures as “a more effective and internationally acceptable approach to stimulating the economy”.

Tax expenditure represents the revenue that is forgone which developed economies calculate on an annual basis (Hungerford, 2006:4). The OECD average for tax revenue percentage of GDP is 34,3 percent (OECD, 2017:9) while the South African tax revenue percentage to GDP ratio for 2017 is 26,4 percent (National Treasury and South African Revenue Service, 2017:1). Appendix B of the Budget Review of South Africa (National Treasury, 2017:127) estimated tax expenditure for the 2014/2015 year of assessment amounted to R139,1 billion an amount equivalent to 3,6 percent of GDP. This forgone tax revenue can be argued either as representing incentives that promote investment and economic growth or an amount representing an erosion of the tax base (Budget Review. South Africa, 2017:127).

While tax expenditure is an inherent feature of some tax systems , including the Income Tax Act (No.58 of 1962), Barrios *et al.* (2016:2) expressed caution when implementing tax expenditure as they believe the:

fiscal and equity impact is not always clear and their effectiveness and efficiency as a policy instrument needs to be carefully evaluated, especially in the present context of constrained public finances.

When tax expenditure is computed progressivity of the tax system as a whole is affected resulting in an adverse impact on vertical equity issues with Barrios *et al.* (2016:2) further emphasising the social viewpoint where transparency is reduced and regressivity can sometimes be proved. Tax policy experts in the United States believe tax expenditures act as loopholes without promoting the economic and social goals originally intended and concluded tax expenditures were often giveaways for the rich and powerful (Steinmo, 2003:216–217) which amplified the inequities of the tax system making it a highly controversial and difficult topic (Barrios *et al.*, 2016:2). Efficiency and effectiveness of the tax system may also be affected depending on the extent of the use of tax expenditures and are often linked to distortions in the tax system (Barrios *et al.*, 2016:2).

The next section will examine the extent of the use of tax expenditures in the current South African tax legislation.

### **5.3.2 The South African Situation**

After the inclusion of all gross income earned, the Income Tax Act (No. 58 of 1962) exempts or deducts certain amounts from taxpayers to reduce the taxable income earned. Taxable income is the amount on which tax is levied either progressively for natural taxpayers or proportionally for business entities. These exemptions and incentive allowances are housed in different sections (commonly from Section 10 to section 24) of the Income Tax Act (No. 58 of 1962), the

first being Section 10, which is commonly referred to as exempt income. Section 10 of the Income Tax Act (No. 58 of 1962), the first of the tax expenditure sections, allows for amounts to be exempted from the tax net after inclusion by section 1 (gross income) of the Tax Act. Hall (1999:7) believed the variable practice of affording different exemptions to different types of taxpayers disregards the basic economic principles of equity.

Section 11 of the Income Tax Act (No. 58 of 1962) further enhances this equity inconsistency by allowing general deductions in the determining taxable income of any person carrying on a trade only. Section 11 is divided into subsections that range from subsection (a) to subsection (x) which all allow for deductions of various types to entities engaged in a trade only. Section 12 extends the net of incentive allowances for entities engaged in a trade providing wear and tear allowances on certain capital assets. Section 13 of the Income Tax Act (No. 58 of 1962) further intensifies these by allowing for deductions in respect of buildings used in the process of manufacture, research and development or any similar process while Sections 15 to 24 supplement the deductions available exclusively for business entities or those involved in a trade.

Certain expenditures which are available either only to business entities or individual taxpayers may be perceived to challenge the principles of horizontal and vertical equity and may be observed as being unfair by the taxpaying community (Fuest & Riedel, 2009:2). After the inclusion of all income into gross income, the subsequent elimination of any exempt income in terms of Section 10 of the Income Tax Act (No. 58 of 1962), the deduction of these tax expenditures result in taxable income, the amount on which tax is levied irrespective of taxpayer type.

However, the calculation of taxable income and the computation of taxes payable are further affected by special rebates which are offered to individual taxpayers or natural persons only. These rebates are contained in Section 6 of the Income Tax Act (No. 58 of 1962) where a primary rebate is offered to taxpayers who have not attained the age of 65 at the end of the year of assessment, a secondary rebate for taxpayers between the ages of 65 and 74 and a tertiary rebate for those taxpayers who are 75 years and older (SAICA, 2019:38–39). This rebate is the amount by which tax payable is reduced contrary to the exemptions and incentive allowances which have the effect of reducing taxable income rather than tax payable. Individual taxpayers are also given relief in the form of medical fees scheme tax credit and medical expenses tax credit. Section 6A further reduces tax payable by allowing a medical scheme fees tax credit which is a rebate for amounts paid to medical schemes by natural persons with the rebate amount being reviewed annually (SAICA, 2019:39). Section 6B allows for a further reduction of tax payable in the form of an additional medical expenses tax credit (SAICA, 2019:40) which

unfortunately will apply to certain individual taxpayers only depending on the amount spent on additional medical expenses during the year of assessment. This section is reviewed and revised annually.

Section 6*quat* grants a further rebate from tax payable to all taxpayers who have received income from a foreign source and on which foreign tax has been levied (SAICA, 2019:41). This rebate differs from Sections 6, 6A and 6B which offer rebates to natural persons only questioning the equity related principles of these.

The plethora of tax expenditures and rebates offered by the current tax policy in South Africa sometimes lead to unintentional consequences.

### **5.3.3 Consequences of Tax Expenditures**

The use of incentive allowances for business entities is favoured in developed countries rather than in developing countries (Swift, 2006:1) as the advanced infrastructure in developed countries reduces tax evasion and the growth of a shadow economy. Tax expenditures are employed in high, transition and low income countries although the purpose differs in each of these (Swift, 2006:2). Supporters of tax expenditures argue that allowing certain types of economic behaviour result in positive external effects while detractors of the concept indicate the potential decrease of the tax base and an increase in the deadweight loss (Section 3.6 and Section 4.3.2 ) from the income tax (Ireland, 2014:27; Saez, 2004:2658; Swift, 2006:2).

The various exemptions, rebates and credits allowed to individual taxpayers is consistent with the Hungerford (2006:2) view that these tax expenditures should be restricted to progressive tax systems.

Toder (2000:362) observed that “tax expenditures[sic] make the tax system worse according to the goals of fairness, efficiency and simplicity”. Bird (2008:9) further noted excessive use of tax expenditures complicates tax administration processes while facilitating tax evasion and encouraging corruption.

A further setback with the definition of income employed in the current South African legislation is its accurate practical implementation by the regulating body. Although theoretically sound, practically this system is cumbersome with the administrative complexities of evaluating the deductions resulting in higher administrative and compliance costs for both the tax regulator and the taxpayer.

With the aim of minimising compliance and administrative costs and maximizing revenue potential it would be imperative to heed the fundamental principles forwarded by Bird (2015:37) who established:

The key to success lies in evolving a strategy that best utilises the available resources to minimise the scope for non-compliance and to maximise the likelihood of detection and punishment of non-compliance, while simultaneously providing facilities and incentives for compliance at each stage of the compliance process.

The importance of tax administration in influencing economic development and developing an effective state was further emphasised by Bird (2015:23). Although it is believed tax incentives for certain classes of taxpayer tend to encourage economic activity reducing unemployment and enhancing economic growth (Fichtner & Feldman, 2013:11), tax principles need to be equitable and fair.

Administration of the Income Tax Act (No. 58 of 1962) is the function of the South African Revenue Service (SARS), an autonomous organ of the State, which was created by the the South African Revenue Service Act 34 of 1997 (The Davis Tax Committee, 2017:7). The South African Revenue Service serves to administer and comply with the modifications and alterations made by any new legislation that affects tax policy in South Africa.

#### **5.4 The Current South African Tax Situation**

Tax policy should address all forms of taxation and ensure an equitable, efficient and fair tax process for all taxpayers. A good tax system should be the ultimate goal to maintain effective and inclusive economic growth (Carnahan, 2015:169) The current taxation system in South Africa levies a progressive tax on individual taxpayers on all income earned irrespective of the nature of income. Although this study is not meant as a comparison of PIT and CIT, the implications of a fixed and flat tax on corporate and business entities with various tax expenditures can initiate a tax arbitrage response. Natural persons may perceive this lower corporate tax rate as inequitable resulting in realignment of tax status leading to tax arbitrage with the following comments on both personal and corporate tax systems being forwarded by various authors.

Steenekamp (2012:51) described the current South African tax system as a semi-comprehensive system which encourages taxpayers to structure their tax affairs to manipulate deductions, allowances and after-tax rate differentials encouraging tax arbitrage and avoidance as previously noted by McCaffery (1999:251):

The rich and clever can avoid paying taxes altogether, while the middle classes continue to toil under ... an onerous wage tax system.

A good tax system would serve to eliminate any potential for manipulation or arbitrage with the Davis Tax Committee commenting on equity and efficiency capabilities of the present tax system endorsing the idea forwarded by Steenekamp and McCaffery above (The Davis Tax Committee, 2014:11).

Although Steenekamp (2012:48) criticised the redistributive functions of personal income taxes, The Davis Tax Commission considering the principles of a good tax system, reflected their views on the South African personal income tax system in Table 5.1 below.

**Table 5- 1: Evaluation of the South African personal income tax system against the principles of a good tax system**

<b>Economic principles</b>	<b>Evaluation of current personal income tax system</b>
1. Efficiency (economic and administrative)	There are concerns that high marginal tax rates disincentivise labour supply (either in terms of participation or working hours). The international mobility of skilled and semi-skilled workers in an internationally integrated labour market represents a further factor to be considered.
2. Equity, fairness	The PIT structure is progressive. The PIT 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. To the extent that capital gains accrue primarily to upper income taxpayers, the progressivity of the income tax and hence the vertical equity of the tax system were enhanced.
3. Transparency and certainty	The simplification of the PIT system and the introduction of e-filing have made the system admirably transparent and simple.
	Transparency is also enhanced by the fact that bracket creep is kept in check by regular adjustments of the brackets and rebates on an ad hoc basis.
4. Flexibility/Buoyancy	The PIT is an automatic stabiliser due to its built-in flexibility to counter-cyclical economic behaviour.

(The Davis Tax Committee, 2014:20, , 2016:21)

A review of the above concerns confirms efficiency, equity and transparency digressions in the current personal income tax system that need to be addressed. A brief overview of the tax statistics produced by the Department of National Treasury and the South African Revenue

Service highlight some of the above concerns emphasised by the various tax commissions in relation to revenue collected in the light of growing international interest in the ability of developing countries to collect domestic revenue effectively (Carnahan, 2015:170).

## **5.5 Revenue collection and Efficiency**

The National Treasury in conjunction with the South African Revenue Service have published a comprehensive breakdown of revenue received since 2008 (National Treasury & South African Revenue Service, 2008). The revenue collected by the South African Revenue Service highlights the amounts in monetary terms and as a percentage of the total revenue collected. Total revenue comprises personal income tax (PIT); corporate income tax (CIT); Value-Added Tax (VAT); Import VAT and Custom Duties and other taxes. This research will concentrate on the tax received from PIT, the collection of which has increased from 29,8 percent of total revenue in the 2007/2008 year of assessment (National Treasury & South African Revenue Service, 2008:6) to 37,2 percent of total revenue in the 2016/2017 year of assessment (National Treasury and South African Revenue Service, 2017:8). Bird & Zolt (2005:1629) confirmed personal income tax was the primary source of income to reduce inequality in developed countries and was measured either against total revenue collected or GDP but questioned whether this system is appropriate for developing nations. . The Minister of Finance in the 2018 Budget speech announced a one percentage point increase in the VAT rate which further adversely affects individual taxpayers and non-VAT vendor businesses as VAT is levied on final consumption. This ultimately increases the tax burden on natural persons and non-registered VAT vendors, although it is a consumption rather than an income tax, possibly resulting in further inequities.

From the available official statistics it is evident that revenue collection in South Africa is largely concentrated on personal income tax, which although progressive may be the result of a system that emulated a developed nation (Bird & Zolt, 2005a:1630) and not suitable for a developing country. With the economic issues of equity and fairness at the forefront of research into taxation principles a review of the income tax system is imperative. The current income tax system has been reviewed several times during the period from 1994, when South Africa became a truly democratic state, resulting in the appointment of at least two Commissions of Inquiry into the tax system.

### **5.5.1 Post 1994**

The appointment of the Katz Commission of Inquiry into Taxation (Katz Commission) (Steenekamp, 2012:41), was the first post 1994 commission of taxation to examine the

increased burden placed on personal income tax. The first Katz Commission interim report was released in 1994 followed by a further nine reports between 1994 and 1999. The Katz Commission (1994:11) recognised the inequities apparent in the personal income tax structure and rates, the narrow tax base and the inefficient revenue collection method.

Taxation principles are viewed as a symbol of political and philosophical options (Bird & Zolt, 2005a:1631) with the transition to a pure democracy in 1994 experiencing many difficulties especially highlighted in taxation reform (Joint Standing Committee on Finance, 1996:2). Although taxation principles should encompass economic values, political pressures tend to divert tax policy from the targeted economic objectives. Being a developing country the redistributive nature of taxation could not be ignored (Bird & Zolt, 2005a:1634; Carnahan, 2015:169) with pressure on the newly elected democratic government to either increase the value added tax rate, which was not recommended by the Katz Commission, or accomplish the task of increasing revenue by policy interventions and increasing economic growth rates (Katz Commission, 1994:12).

Following the advice of the Katz Commission, the Income Tax Act (58 of 1962) has undergone numerous adjustments and modifications albeit on a piecemeal basis, although this method was warned against in the First and Third Interim Report of the Katz Commission (Joint Standing Committee on Finance, 1996:3). Internationally, personal income tax is considered significant due to (Bird & Zolt, 2005a:1635) its visibility with Forstater (2018:8) highlighting the importance of the maximization of effectiveness of tax policy. Good tax policy should be fair and understandable, enhance economic efficiency and reduce administrative and compliance costs (Forstater, 2018:9) which begs the question whether the resultant supplements and appendages to the Income Tax Act considered the principles of equity, fairness and efficiency (Joint Standing Committee on Finance, 1996:3–4).

### **5.5.2 Tax Policy Consequences**

Good tax policy decisions, although country specific, fundamentally balance economic, administrative and compliance costs while raising adequate revenue (Carnahan, 2015:173). These policy objectives, coupled with the redistributory function of taxes in developing countries possess the ability to balance efficiency losses against equity gains (Bird & Zolt, 2005a:1673). The Khaldun fourteenth century view (discussed in Section 3.3.4.2) advances the view that heavy taxation discourages taxpayers from working resulting in lower total tax revenue collected by governments even when the tax rate is increased (Ismail & Jaafar, 2014:3). Economic growth can be stimulated by decreasing the individual tax rates thereby increasing taxpayer confidence psychologically providing an incentive to work harder ultimately improving total tax

revenue (Ismail & Jaafar, 2014:3). The economic climate of South Africa necessitates tax policy that fulfils the roles of adequate revenue collection and the redistributory demands.

However, The Davis Tax Committee (2016:26) found although highly progressive, the PIT system does not reduce income inequality significantly. Practically, aggrieved individual taxpayers have the options of either registering business entities to enjoy the special deductions and allowances, or illegally evading tax further reducing the already minute tax base and increasing non-compliance (Fuest & Riedel, 2009:5). This non-compliance issue results in further inequities in the tax system, both economic and non-economic ultimately reducing total revenue received by the State without fulfilling the redistributory role.

Tax reform measures should be mindful of horizontal and vertical equity principles, administrative efficiency and compliance issues. Taxpayer perception is furthermore an important aspect of tax reform which requires attention (Section 4.6.1). Attitudes and perceptions of taxpayers may result in non-compliant tax behaviour (Carnahan, 2015:177; Fuest & Riedel, 2009:5), discussed in detail in Section 4.6, a situation South Africa could ill afford. Taxpayer compliance directly affects tax revenue yield, efficiency and equity principles of the tax system (IMF, 2015:6).

Unlike its developing counterparts where revenue from PIT compared to GDP is between 1-2 percent (Carnahan, 2015:176), South Africa's PIT to GDP ratio is in the region of 10 percent (National Treasury and South African Revenue Service, 2017:9). This indicates a significant portion of total revenue is obtained from individual taxpayers with corporate tax collections playing a secondary role, an occurrence noted in developed countries rather than in developing countries (Tanzi & Zee, 2000:307).

The amount of revenue earned from PIT (36,4 percent) as a percentage of total revenue has doubled in comparison to the amount received from CIT (18,1 percent) in the 2016 year of assessment bringing with it new challenges regarding tax policy amendments (National Treasury and South African Revenue Service, 2017:8). The 2017 year of assessment indicates the amount collected from corporate entities (18,1 percent) as a percentage of total revenue collected is less than half that collected from natural persons (37,2 percent) (National Treasury and South African Revenue Service, 2017:8). These ratios highlight the burden placed on PIT in South Africa coupled with a consumption tax (VAT) of 15 percent levied on most consumer products, by end users who are either non-VAT registered businesses and natural taxpayers. The South African tax system currently, when empirically investigated reveals a tax system that is consistent with that of a developed rather than a developing country as Bird and Zolt (2011:1691) remarked:

In contrast to developed countries where personal tax revenues are often 3–4 times greater than corporate tax revenues, developing countries generally receive more revenue from corporate income taxes than personal income taxes, with the share from the personal income tax declining over the last 20 years.

The economic principles of equity, efficiency and fairness were addressed by The Davis Tax Committee (2016:85) who concluded that although PIT has been found to be efficient arbitrage opportunities exist between the PIT and CIT maximum tax rates with more affluent taxpayers diverting income into corporate structures to benefit from the favourable rates and incentives afforded to corporate structures. They also concluded CIT administrative principles were found to be open to manipulation, less certain and less transparent than PIT administration structures (The Davis Tax Committee, 2016:87) affording avoidance opportunities affecting the economic principles of good tax policy.

High personal tax rates may be levied to provide the required revenue but may impact economic growth adversely and reduce global and regional competitiveness. This phenomenon was verified with Young and Saltiel (2011:5) observing:

Evidence from Britain and around the world tells us that punitive tax levels raise less revenue than modest rates.

The consequence of high tax rates is poor or no economic growth in developed countries with governments collecting less than the optimum amount of revenue needed (Besley & Persson, 2014:109) with this problem exacerbated in developing countries. The lack of economic growth encourages recessionary measures which further decrease the (Besley & Persson, 2014:110) amount of revenue collected by the State intensifying the underlying crisis of unemployment. Developing economies are faced with even harsher problems as their tax bases are relatively smaller than those of developed countries (Bird, 2008:2). However, most countries have shown an increase in tax revenue when tax rates have decreased consistent with the principles of the Laffer curve (Young & Saltiel, 2011:14) discussed further in Section 6.3.1.

To summarise South African tax policy measures need to consider a growth maximising level of taxation rather than the punitive tax rates applicable to high income earners. High personal tax rates are counter-productive if these revenue maximising levels result in economic impairment. Coupled with the extremely small tax base, high marginal personal tax rates may be ineffective and unproductive. High personal marginal tax rates do not adhere to the basic economic principles of equity, efficiency and fairness. As noted by Tanzi and Zee (2000) and substantiated by Bird and Zolt (2011) personal income tax collections in a developing country

should be lower than that of corporate revenue collections. The official tax statistics published by National Treasury and South Africa Revenue Services reveal corporate revenue collection is at least half that of revenue collected from personal income tax, a feature distinctive of a developed country, a situation which needs to be addressed.

An important consideration when analysing tax rates and structures is the study of public finance particularly for developing countries where the output is regulated by large agricultural sectors and many small organisations (Di John, 2006:3) which may impact the type of tax imposed. The revenue system in developing countries, while assisting in the reduction of inequality, should promote effective, accountable and stable governments (Carnahan, 2015:169) to contribute towards economic and employment growth further highlighting the important role of taxation.

## **5.6 Issues Relating to Public Finance**

Public finance is a branch of economics that studies the role of taxation and government spending behaviour (Rosen, 2008:369). The issues dealt with in public finance relate either to positive analysis encompassing the effect of a price reduction or normative analysis which considers ethical issues like the method of taxation (Rosen, 2002:1).

Taxation theory, practically, is dependent on various other non-economically related factors. Competitive political systems necessitate the choice of tax structure based on political support rather than economic requirements. Kenny and Winer (2006:183) deduced tax systems are based on:

competition between political parties for support from heterogeneous voters (which) forces the government to choose a tax structure based on the loss in support -or, political costs-associated with different tax sources.

Tax systems affect voters by reducing their disposable income and influencing the welfare loss linked to economic modifications in response to taxation (Kenny & Winer, 2006:184). The perfect tax mix will, however, depend on the level of education, the size of the democratic state, allegiance to a particular political party and economic circumstances (Bird, 2008:2). Di John (2006:1) emphasised the importance of designing tax systems, particularly in Sub Saharan Africa, that provide incentives for growth while simultaneously meeting distributional demands to ensure viability and effectiveness of the State.

### 5.6.1 Taxation Methods

Public finance is limited to the economic ability of the democratic state to impose and collect taxes and the taxpayers' obligations towards the State. This economic approach, while examining the trade-offs between efficiency and equity concurrently with levels of development and the economic structure of tax structures and rates, does not consider the broader role and importance of investment in developing countries (Di John, 2006:4).

Public finance experts believe tax should be levied on accurate and precise income levels, whereas some countries levy tax on a presumptive amount legally defined by appropriate indicators (Tanzi & de Jantscher, 1987:1) using a tax on average income rather than actual income. Presumptive taxation uses indirect methods to ascertain tax liability for a variety of reasons which include simplification of complex calculations, avoidance of tax evasion, political and technical difficulties in addressing certain problems (Thuronyi, 1996:2). Presumptive measures can also be applied to ease the administrative burden and achieve efficiency and equity goals (Tanzi & de Jantscher, 1987:1).

Although the simplest form of taxation is believed to be a tax on income, Seligman (1914:18) stated:

Even if the income tax were the fairest of all taxes--which. . . is not necessarily true-- the decision as to whether it ought to be utilized would depend largely upon whether this fairness which is predicated of it in the abstract, would ensue in actual practice. It is notorious, however, that of all taxes the income tax is perhaps the most difficult to assess with scrupulous justice and accuracy; so that what is conceived in justice often results in crass injustice.

An increased dissatisfaction with taxing of income has inspired alternative methods of levying taxation in certain jurisdictions (Bird & Wilkie, 2012:12). Administrative complexities, efficiency apprehensions and equity anxieties led to the review of the method of taxing income. Tanzi and de Jantscher (1987:4) cited the accuracy of actual income proved difficult with a small tax base resulting in presumptive income being a simpler method of measure. The use of actual income resulted in scope for tax evasion, the growth of the underground economy and shrinkage of the existing tax base (Tanzi & de Jantscher, 1987:4). When efficiency of a particular tax is considered, policy makers should reflect on the effect of high tax rates on work ethic, saving and entrepreneurship. Tax evasion creates an inequitable scenario which requires careful consideration when designing tax reform policy.

## 5.6.2 Tax incidence

Tax incidence is another important factor when analysing tax reform policies (discussed previously in section 3.6). The legal responsibility of paying tax is referred to as statutory incidence (Rosen, 2008:375) while the economic incidence of a tax is the alteration in the distribution of private income post tax (Fullerton & Metcalf, 2002). Tax incidence can subsequently be defined as the economic term that describes the tax burden (Fullerton & Metcalf, 2002). The phenomenon of tax incidence ultimately influences the efficiency of tax systems.

Taxes distort economic behaviour creating a loss in welfare that may exceed the revenue collected. This phenomenon is known as excess burden with the more responsive taxes producing a greater excess burden (Rosen, 2008:376) (Section 3.3). Excess burden, much like tax incidence, differs with behavioural responses to the tax (Rosen, 2008:376). When a tax generates a large excess burden, the tax is inefficient. Buchanan (1993:401) referred to an inefficient tax structure as one that reduces the economic value below :

that which might be potentially achievable within given resource and technology constraints and within the particular political-legal order that exists.

The efficiency of a tax structure based on the concept of excess burden is utilised when designing an optimal tax system as an efficient tax would generate low excess burdens. However, public finance economists believe there is a trade-off between efficiency and fairness (Bird & Wilkie, 2012:10; Di John, 2006:1; Piketty & Saez, 2013:456). Conventional economists believe horizontal equity, the notion where equals are taxed equally, and vertical equity, the distribution of burdens fairly across taxpayers with different abilities to pay are the most important tax policy measures (Rosen, 2008:378). Spicer (1995:106) argued the principles of horizontal equity should be enhanced to include neutrality, representing a uniform tax across different economic activities that should not restrict market decision making. Taxes should not enhance certain economic activities financially and should not embrace discriminatory policies that encourage potentially harmful outcomes (Spicer, 1995:106). Potential optimal tax structures are designed envisaging other economic factors affecting the total revenue collection. The trade-off between efficiency and equity is exacerbated when political issues are considered (Bird & Wilkie, 2012:11; Norregaard & Khan, 2007:5). Another important consideration is the effectiveness of the tax system, a concept which “refers to the extent to which taxes are predictable, transparent, and enforced by a fair judicial system” (Di John, 2006:5).

Conversely, tax structures may be created, in a democratic society, by the ruling majority who may have no desire to implement efficient, effective or optimal tax structures. However, with greater equality and fairness being at the forefront of international economic and social debate, tax reform should focus on socioeconomic issues by implementing effective economic and fiscal policies (Bird & Wilkie, 2012:5–13; Norregaard & Khan, 2007:5). Attempts towards the implementation of a fair tax system should encompass economic, social and macroeconomic conditions (Bird & Wilkie, 2012:12). Tax reform policies may be jeopardised by compliance issues such as an inherent distrust of the state due to high corruption levels as well as weakened and fractured political structures.

### **5.6.3 Tax Policy and Tax reform: the differences**

Tax policy is defined, by PriceWaterhouseCoopers in *An Overview of Tax Policy and Administration* (2017), as a key component of fiscal policy, referring to what taxes governments choose to levy, in what amounts, and on whom. Tax policy involves broad issues relating to the amount of tax the government needs to collect in order to compensate for expenditure and the effect taxes can have on overall economic activity (Bird & Wilkie, 2012:2). It also affects issues of fairness, who, why, how much and efficiency, or whether taxes will have a distortive effect on economic activity.

Tax reform is defined in Business dictionary.com (2018) as “the method of revising tax laws by the government”. Tax reform is usually undertaken to improve the economic benefits of taxes, increase compliance by improving the efficiency of tax administration and to provide the requisite social benefits. Although tax reform policies are believed to be economically beneficial, tax reductions or increases that fail to produce the required economic boost could result in declining tax revenues resulting in poor economic growth (Engen & Skinner, 1996:617).

The success of fiscal policy is dependent on effective tax policy decisions (Bird, 2008:3). However, tax policy decisions cannot be advanced without adequate consideration of economic policy and its effects (Norregaard & Khan, 2007:3). Since the dawn of democracy in 1994, at least two tax commissions were appointed to analyse current tax legislation and propose improvements to the Tax Act in an attempt to improve the economic status of the country. A brief overview of these findings follow for purposes of completion.

## **5.7 South African Tax Reform Commissions**

When South Africa progressed to a full democratic state in 1994, the tax base was admittedly not representative of the population with significant economic shortcomings that needed to be addressed. To enable satisfactory revenue and economic outcomes were achieved, adequate

information relating to the tax status of the country was essential. This necessitated the creation of at least two tax commissions since 1994, the first being the Katz Commission of Inquiry into Taxation (Di John, 2006:10; Steenekamp, 2012:41).

### **5.7.1 The Katz Commission of Inquiry into Taxation**

The Katz Commission, formally known as the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, was formed to address these concerns. The Commission produced nine interim reports until 1999 and was influential in advancing a significant number of tax reforms during its existence. The terms of reference of this Commission were extremely broad including an investigation into:

personal income tax with special reference to gender, the tax base, tax thresholds, tax rates, income brackets, progressivity and fiscal drag (Manuel, 2002:3)

Although equity issues were considered by the Katz Commission there were numerous hurdles that needed to be addressed, particularly with the reintegration of South Africa into the global economy and the termination of the apartheid era tax policies (The Davis Tax Committee, 2016:6). Faced with the challenging task of incorporating economic principles and political intentions, the Commission encountered many criticisms due to the absence of an analytical framework.

The "incremental" approach to tax reform which the Commission calls for is acceptable in principle, but the link between the specific proposals and the bigger picture is not always clear. There is a need to avoid the "incremental" approach becoming "piecemeal", leaving uncertainties as to where the process is, where it is going and when it might get there... It appears that through the absence of the necessary "big plan" there seems to be an inability comprehensively to consider possible consequences and to balance and integrate different facets of thinking emerging from the Commission's investigatory work

(Joint Standing Committee on Finance, 1996:3).

Manuel (2002:4) referred to the post Katz Commission period as a "period of fiscal and macroeconomic consolidation" while highlighting the significant personal income tax reform principles that were implemented. Personal income tax raised the most taxes (Manuel, 2002:4) and retained its progressiveness post Katz Commission reform. Aaron and Slemrod (1999:3) highlighted the importance placed on personal income tax (and value-added tax) as the primary revenue producer by the South African tax system with apprehension. This reliance on personal income tax was further exacerbated by the minute personal income tax base (Steenekamp,

2012:44) although broadening the tax base was considered an important tax reform measure (Manuel, 2002:5) in the Katz Commission report. This reliance on personal income tax and other recommended reforms initiated major criticisms of the Katz Commission which included the lack of quantitative reinforcement and the absence of fundamental tax reform (Aaron & Slemrod, 1999:8).

The global financial crisis of 2008 resulted in a recession which instigated the creation of the Davis Tax Committee which was formed to analyse and advise on the impact of tax reform methods on economic growth and revenue collection.

### **5.7.2 The Davis Tax Committee**

Following the Katz Commission along with efforts to broaden the tax base and reduce personal marginal tax rates, South Africa still faced many economic and social challenges including persistent unemployment, poverty and inequality (Ministry of Finance Republic of South Africa, 2013:2) It was believed that a revamp of the economic and fiscal policy framework was essential resulting in the appointment of the Davis Tax Committee with its terms of engagement being:

to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability

(Ministry of Finance Republic of South Africa, 2013:1)

The Davis Tax Committee was mandated to, among other issues, examine the tax mix and the tax burden of direct and indirect taxes with their ultimate goal being the generation of sufficient and sustainable revenue in the long run (Ministry of Finance Republic of South Africa, 2013:2). An overview of personal income tax, as a major contributor to total revenue, was undertaken by the Davis Tax Committee as part of its instruction.

The Davis Tax Committee found that the tax system is influenced by various economic and political impediments which ultimately affect the tax structure and fiscal policy decisions.

The role of the tax system cannot be divorced from broader fiscal and macro-economic policy or from more general conceptualisation of the role of the state itself within a particular political system. Increases in the size of government and the complexity of its functions have, over time, led to far reaching consequences for the tax system. Far from merely being a mechanical, technical exercise in economic analysis, tax policy is inherently political and ideologically contested, moulded by the dynamic interplay among economic and political institutions, interest groups and political values and

culture (e.g. the degree of tolerance of inequality or the perceived legitimacy of government) (The Davis Tax Committee, 2016:8).

The state-citizen relationship was similarly highlighted by Carnahan(2015:169) as the reinforcement that supports an accountable and stable government capable of contributing towards economic and employment growth. With attitudes towards the South African Tax system varying from being viewed as “a coercive, extractive exercise of predatory state power, essentially to maintain the status quo favouring powerful interest groups” to the redistributive mechanism that enhances social justice and nation building to an instrument that corrects market distortions and stimulates growth (The Davis Tax Committee, 2016:8–9), tax policy reforms need to be perfect to ensure adequate revenue collection.

Taxation is an important contract between the State and its citizens in a democratic society (Carnahan, 2015:170; Tengs, 2016:2; The Davis Tax Committee, 2014:8). Although different political goals and values tend to tarnish the ultimate economic goals of the ability-to-pay and benefit principles perceptions of fairness and tax legitimacy are crucial. The Davis Tax Committee (2016:9) highlighted the importance of faultless governance, efficiency and equity of public expenditures and the degree of corruption within the Government. As South Africa relies on voluntary compliance by taxpayers, the importance of perception was highlighted by The Davis Tax Committee (2016:9) with a suggestion of enhanced transparency and public cooperation in the tax policy development process. Tax policy amendments in South Africa need to be compatible with the requirements of the Constitution of South Africa (The Davis Tax Committee, 2016:10) taking into account revenue requirements, socio-economic factors and economically accepted markers. Although all taxes distort economic behaviour, the objective of effective tax policy amendments should be the avoidance of highly distortionary taxes with the aim of competent revenue collection from less distortionary taxes (Engen & Skinner, 1996:626).

Constitutional, political, socio-economic and policy factors affect the articulation of tax policy amendments. The basic objectives relating to revenue-collection, redistribution of resources, correction of market failures, economic policy, influencing behavioural responses and international competitiveness are of utmost importance (The Davis Tax Committee, 2016:13–14). Public sector economics highlights the requirements of efficiency, equity, simplicity, transparency and certainty and tax buoyancy (The Davis Tax Committee, 2016:14) which needs to be fulfilled. Tax buoyancy is described as the ability to raise sufficient revenue during all business cycles while expressing the scope for a counter-cyclical fiscal framework (The Davis Tax Committee, 2016:14). Tax buoyancy, an indicator of the measure of efficiency and responsiveness of revenue mobilization in response to growth in the Gross domestic product or

National income, is very much an economic indicator. A tax is said to be buoyant if the tax revenues increase more than proportionately in response to a rise in national income or output.

The Davis Tax Committee evaluated and suggested certain measures that would improve the tax system in South Africa but it would be idealistic to assume all objectives and requirements of tax policy could be fulfilled by the implementation of a concise tax system. In most economies a compromise between these principles is reached to achieve the most favourable overall result with the trade-off between equity and efficiency being considered important

### **5.7.3 Equity and the Tax Act**

The Davis Tax Committee analysed the tax system in relation to equity principles. Musgrave (1993:2) advanced three pathways in the approach to tax equity, the benefit principle, the ability-to-pay rule and the least total sacrifice or maximum welfare principle.

The two most commonly utilised methods discussed in the 2014 Macro-Analysis First Report and the 2016 Davis Tax Committee Report are the benefit and ability-to-pay principles. The Davis Tax Committee based its discussion on its interpretation of the benefit and ability-to-pay principles as follows:

The benefit principle bases taxes to finance spending on public goods on the willingness of taxpayers to pay for the benefits received (as revealed through political collective choice mechanisms, such as voting). The ability-to-pay principle regards tax paid as a sacrifice for which there is no direct public service quid pro quo and focuses on what is an equitable burden per taxpayer, relative to their wealth.

(The Davis Tax Committee, 2014:8)

South African personal income taxes are progressive consistent with the views of the members of the National Development Committee 2030 (referred to as NDP) (The Davis Tax Committee, 2014:11). The NDP (National Development Plan), however, conceded that based on the current labour market participation and the tax base estimates “there clearly would not be enough tax payers and contributors to ensure state provision, maintenance and sustainability of decent social protection” (National Planning Commission, 2012:366).

Economic principles, particularly vertical equity, according to most economists, favour progressive tax systems whereas Musgrave, (1993:4) argued taxes could be progressive, regressive or proportional to conform with the benefit and ability-to-pay rules, which the Davis Tax Commission based their research on. Coupled with this, the NDP highlighted the scarcity of taxpayers in South Africa requiring further action by the State to expand this tax base which was

likewise stated by Di John (2006:16) who noted the urgent need to expand the coverage of the tax base in developing countries.

To alleviate or reduce this challenge, Reed (cited in Linder, 1996:922) recalled the Laffer curve and encouraged the readjustment of tax rates downwards to encourage productivity, increase the tax base and increase total revenue. The composition of the tax system in any country is indicative of economic growth. Broad-based tax structures, efficient administration of tax systems and effective enforcement of tax laws exert a positive influence on long term economic growth (Engen & Skinner, 1996:636).

Another important factor when considering tax policy reforms in South Africa is an assessment of the Gini Coefficient (Section 4.4.4). This measure of income distribution providing a quantitative measure of the income inequality given a definitive set of economic factors was 0,57 for South Africa in 1989 (Coetzee, 1995:39) with the 2015 Gini coefficient being 0,63 as per World Bank statistics. Borat (2015) expressed concern regarding South Africa's persistently high Gini coefficient of between 0,660 and 0, 696. Comparing the 1989 index with the 2015 index a sharp rise is noted highlighting the acute increase in income inequality (Bhorat, 2015) in South Africa. Alvaredo *et al.* (2018:74) classed South Africa as one of the three extreme inequality regimes in 2018 further emphasising the rise in the level of inequality since 1994. Although the Gini index is internationally recognised, its shortcomings are probably demonstrated in a country with a high shadow economy as all forms of income cannot be detected with (Alvaredo *et al.*, 2018:42) confirming the relative lack of data availability

The as yet to be defined level of income that escapes the tax net in South Africa further contribute to the ill-defined tax policy measures when equity and efficiency measures are considered. The effectiveness of current tax policy is undermined by lack of sufficient, reliable information.

## **5.8 Challenges Faced by South Africa**

South Africa, a democratic, developing country, faces numerous challenges when formulating tax policies especially when the basic economic concepts of efficiency, equity and administrability are considered (Bird, 2008:8; Di John, 2006:4; Tanzi & Zee, 2000:299).

A democratic country was described by Roemer (2008:24) as a set of political institutions which may reduce income inequality through redistribution and reinvestment in the population. The definition of a developing country seems rather more varied and abstract with Inkeles and Smith (1974:323) adopting the view that these are countries who sought liberation from their colonial past and development for entry into modern societies. The World Bank, though, classifies

countries on their gross national income per capita and lending rate, a definition also adopted by the OECD but not the World Trade Organisation.

...World Bank member countries (189), and all other economies with populations of more than 30,000 [are classified where] for operational and analytical purposes, economies are divided among income groups according to 2017 gross national income (GNI) per capita, calculated using the World Bank Atlas method. The groups are: low income, \$995 or less; lower middle income, \$996–3,895; upper middle income, \$3,896–12,055; and high income, \$12,056 or more. (World Bank, 2018).

The World Trade Organisation does not adhere to a specific definition but allows member countries to choose their status based on agricultural output (Kasteng *et al.*, 2004:11) resulting in a rather arbitrary classification. This study will follow definition forwarded by the World Bank.

Developing countries are limited in the efforts on tax reform by numerous economic and non-economic factors. Tax policy decisions must correspondingly consider the administrative dimension particularly based on the income level of the country as the best tax policy is insignificant if there is poor implementation (Bird, 2003:17). Developing countries face varied policy limitations ranging from some having a particularly large agricultural sector which is difficult to tax while other economies are riddled with a large shadow or informal sector resulting in a potentially unreachable tax base (Bird, 2003:17; Di John, 2006:3) and the additional constraints of an uneducated population.

South African lawmakers face the daunting task of formalising a growing informal sector, a fairly large agricultural sector and lower than normal literacy rates (The Davis Tax Committee, 2014:12). Small business owners have not been educated on the importance of the taxation system which adversely impacts compliance. Lack of compliance results in ill-informed tax reform policies coupled with a narrow tax base from which personal income tax is collected (Lewis & Alton, 2015:9). Only 30 percent of the working-age population in South Africa is employed in the formal sector creating this narrow personal income tax base (Lewis & Alton, 2015:9). This narrow tax base provided 37,2 percent of the total income in 2017 and 36,4 percent of the total revenue in 2016 (National Treasury and South African Revenue Service, 2017:8) which was collected by the State highlighting the inefficiencies and inequities present.

Post 1994, particularly over the last two decades the South African tax system has encountered numerous reforms to ensure a balanced well administered tax system (Lewis & Alton, 2015:7). However, a marked concern is the persistently high level of inequality inherent in the Income Tax Act (No. 58 of 1962 (as amended)), the need for economic growth and the issue of job

creation (Lewis & Alton, 2015:7). Numerous underlying challenges are faced by tax authorities of South Africa which may be attributed to the structure of the economy, low literacy rates and low human capital (Tanzi & Zee, 2000:300; The Davis Tax Committee, 2014:12). However, persistent piecemeal amendments to the present Income Tax Act have produced a tax system devoid of economic principles. The post amendment resultant tax system allows the administration to exploit the available options rather than develop modern, efficient tax systems (Tanzi & Zee, 2000:300). With the focus on personal income tax it must be noted that like most developing countries, revenue from personal income tax is restricted to salaries from formal employment (Avi-Yonah & Margoloth, 2007:1) resulting in limitations of the tax base.

Although tax reform literature concentrates on economic growth and social justice or equity without differentiating between developed and developing countries, Avi-Yonah and Margoloth (2007:4) believed the variations in industry type, administrative and compliance costs, levels of corruption, political constraints and the size of the informal economy separate developing countries from developed countries.

### **5.8.1 Tax Administration and Compliance Costs**

The significant role of tax administration in tax reform has been identified and tax policy specialists believe that policy change without the relevant administrative change is ineffective (Bird, 2003:17). When assessing administrative and compliance costs three aspects need to be considered: the number of transactions; the complexity of each transaction and the ease with which the point of transaction can be accessed (Carnahan, 2015:173). Tax administration in South Africa was modernized with the introduction of the Tax Administration Act Number 28 of 2011, which sought to alleviate certain administrative problems with the collection and general administration of the tax system. Although administrative costs are budgeted into tax policy, compliance costs are unaccounted for where compliance costs are costs borne by the taxpayer to adhere to the stated tax laws.

National Treasury and South African Revenue Service (2017:vii) noted a decrease in the 2016/2017 cost of collection as 0,93 percent as compared to 2012/2013 which was 1,07 percent. Although no mention was made of total administrative costs 80 percent of revenue collection in 2017 was primarily from PIT (37,2 percent), CIT (18,1 percent) and VAT(25,3 percent) which was attributed to:

the result of responsive tax policy systems as well as improvements in SARS' administrative efficiency achieved by its continual improvements to its systems and

processes. This enabled the government to maintain a sustainable debt profile during the global economic recovery following the recession.

(National Treasury and South African Revenue Service, 2017:1)

The reduced administrative costs improve efficiency, but these excluded compliance costs. Wenzel (2002:42) adopted an alternate perspective and argued on behalf of the taxpayer maintaining that although there is some exchange between the taxpayer and the government for taxes paid, taxpayers may evaluate whether this exchange is equitable. Tax administration reforms may provide an effective means for sustained and inclusive economic development it must be noted that most tax evasion models assume an individual taxpayer is motivated to augment their personal interests with the possibility that taxpayers identify themselves as part of a social structure and act accordingly (Wenzel, 2002:43). Where a tax system is perceived to be unfair, this then becomes a social protest rather than a personal grievance resulting in widespread tax evasion (Avi-Yonah & Margoloth, 2007:2). Wenzel (2002:44) added a further dimension to the equity predicament when he highlighted the concept of exchange equity together with vertical and horizontal equity. Exchange equity, according to Wenzel (2002:44) relates to “the perceived value of tax-funded government benefits and services received relative to one’s tax contribution”.

This third dimension to the definition of fairness, although psychological, has the adverse effects on tax revenue which can be considerable especially in the political landscape South Africa finds itself currently. The additional costs of corruption were noted by Avi-Yonah and Margoloth (2007:5) which necessitates a closer inspection of tax policy in South Africa where tax policy amendments need to comply with the principles of horizontal and vertical equity, be efficient, effective and administratively simple and consider non-economic factors identified in developing countries.

Although the economic challenges of unemployment and poor economic growth coupled with poor education in certain areas faced by South Africa hinders the adoption of equitable and simple tax practices, tax policy should ideally be non-discriminatory unless special incentives are provided for certain taxpayers which should be transparent, simple and effective (ACCA, 2009:4). Transparency of special incentive allowances proves invaluable when considering fairness and perception of a tax system. The complexity of tax policy is directly proportional to the number of incentives allowed to certain groups of taxpayers (ACCA, 2009:4). A non-transparent, complex tax system reduces compliance among existing taxpayers (Di John, 2006:5) and reluctance to register as taxpayers by potential new taxpayers. This results in a reduced tax base, lower revenue collection and an increased underground economy. A vastly

complex tax system also encourages tax evasion and capital mobility among affluent taxpayers (Di John, 2006:19), a well-documented fact:

Creating the commitment of citizens not to evade taxation is a political process central to state building; cajoling elites to pay taxes has always been an essential step to any state becoming effective. (Everest-Phillips, 2012:70).

The inequality index is a further unfavourable factor in South Africa when considering tax reform policies as this may affect the aggregate level of taxes (Bird & Zolt, 2005a:1660). Several challenges affect tax compliance and future tax design issues in countries with extreme inequalities facing the additional difficulty of raising taxes in a fair and efficient manner (Bird & Zolt, 2005a:1660).

Another contributing factor to tax policy decisions is the effects of globalisation with a review of the important aspects of globalisation being essential to understand the problems faced by South Africa.

### **5.8.2 The Effects of Globalisation**

Globalisation has encouraged capital mobility with investors seeking the highest rate of return on international markets (Di John, 2006:19; Swank & Steinmo, 2002:645). The economic downturn of the 1970s which resulted in increased tax incentive allowances proved unproductive with the subsequent shift to lower tax rates and less tax based incentives resulting in a more efficient allocation of investments and increased economic performance (Swank & Steinmo, 2002:646) globally. Although overall efficiency can, be improved by incorporating the informal economy and its employees into the official economy (Auriol & Warlters, 2005:627) developing economies tend to operate informally rather than formally, a behavioural consequence of the system (Bird & Zolt, 2005a:1662). Everest-Phillips (2012:70) deduced tax evasion is correlated with dissatisfaction with government policies, weak governance and political interference in economic policy decisions. High prevalence of tax evasion may indicate political instability where the ruling government is viewed as being unjust in their tax policy decisions.

Globally, the choice of taxation systems is largely dependent on the choice between taxing income and taxing consumption. Income tax is dependent on the definition of income, as discussed earlier in Section 4.3.3, while consumption tax taxes consumption only. Many jurisdictions, including South Africa, levy tax on both income and consumption. Lessons relating to the choice of a tax system can be learnt from other less-developed countries rather than from developed countries (Ahmad & Stern, 1989:1016), a view held by numerous authors (Avi-Yonah

& Margoliath, 2007; Bird & Zolt, 2005a). Direct taxation requires proper design, administration and implementation to be effective (Ahmad & Stern, 1989:1016). With limited administrative capabilities, less developed countries may experience the need to incorporate a changing mix of taxes (Ahmad & Stern, 1989:1016; Di John, 2006:2). The mix of taxes needs to be fair, efficient and equitable to all taxpayers.

Of particular concern, especially in developing economies, is the unequal distribution of income and its relative impact on vertical equity principles (Tanzi & Zee, 2000:306) with South Africa's being categorised among the most unequal in the World. (Section 5.7.3).

Tax policy decisions should encourage domestic taxpayers to remain in their jurisdictions ensuring adequate revenue collection which will ultimately result in economic growth and effective redistribution of income.

### **5.8.3 Inherent Inadequacies of Effective Tax Systems**

South Africa, consistent with other countries in the African continent, is plagued by poverty and high unemployment (Steenekamp, 2012:41), but is an area that can benefit from Cottarelli's (2011:4) philosophy where he highlighted the importance of substantial amounts of additional revenue in developing countries.

However, increasing revenue by taxing compliant taxpayers can result in distortions and inequities decreasing the total tax revenue collected (Cottarelli, 2011:4).

Tax authorities need to be seen as a service provider with tax compliance being divided into the power yielded by the tax authority and the trust portrayed by the tax authority to the tax paying public (Kirchler *et al.*, 2008:211) to encourage tax compliance. The tax climate needs to be favourable with Kirchler *et al.* (2008:211) highlighting the difference between an antagonistic tax climate and a synergistic tax climate:

In an antagonistic climate, taxpayers and tax authorities work against each other; in a synergistic climate, they work together. The antagonistic climate can be characterized by a "cops and robbers" – attitude on both sides: tax authorities perceive the taxpayers as "robbers" who try to evade whenever they can and need to be held in check; taxpayers feel persecuted by the authorities ("cops") and feel it right to hide.

The importance of the impression created by the tax authority cannot be emphasised enough as this either encourages or discourages taxpayers to be compliant. South Africa, consistent with most developing countries is starved of adequate revenue, requiring tax authorities to adopt a synergistic rather than an antagonistic role. The impact of tax noncompliance has adverse

connotations affecting the provision of government services and the socio-economic wellbeing of the country.

With the ultimate aim of tax reform policy being to increase total revenue for redistributive purposes without encouraging further non-compliance which will magnify the existing problems, tax compliance issues are an important factor and should be carefully considered. Progressive personal income tax influences the behaviour of taxpayers especially in developing countries (Bird & Zolt, 2005a:1662) with high progressive tax rates influencing “the choice between formal and informal employment arrangements. Periods of economic downturn have been associated with an increase in the shadow economy (Section 4.6.2) further decreasing revenue levels (Viksne & Mazure, 2011:219). An administratively complex tax system with a perceived inequity further hinders the collection of revenue (Di John, 2006:5) resulting in an increased shadow economy and a subsequent decrease in total revenue collected. The shadow economy also impacts on future state development due to incorrect statistical feedback relating to various aspects of the economy (Viksne & Mazure, 2011:225). Incorrect statistical data have an adverse effect on economically related legislation such as the tax system with simplicity of tax legislation and inherent equity principles being competing goals when tax reform is considered. Surrey and Brannon (1968:915) further highlighted the importance of a simple tax system with

Simplicity is the characteristic of a tax which makes the tax determinable for each taxpayer from a few readily ascertainable facts.

The above definition leads one to believe that simplicity of tax legislation would encourage taxpayers not to avoid or evade tax as they would not require great skill to calculate taxes due to the State. There are, unfortunately, other factors that affect compliance of tax paying citizens complicating tax reform procedures. An equitable tax should make the relative burden of tax on the taxpayer as light as possible (Surrey & Brannon, 1968:915).

The above discussion begs the question relating to the existence of both simplicity and equity together with efficiency and effectiveness in a developing country. Although this question can be answered in relation to all Sub Saharan African countries it is restricted to productive tax reform systems that would be effective in the South African context. The Sub-Sahara African region boasts afloat tax that was adopted by Mauritius which is simple, easy to understand, equitable, efficient and effective. The tax system of Botswana reveals stable features that encourage taxpayers to be compliant resulting in it being considered simple, equitable due to the low maximum marginal personal tax rate, efficient and effective by Sub Saharan African standards.

However, in the South African context, the complexity of the Income Tax Act (No.58 of 1962 (as amended)) poses serious problems when compared to neighbouring countries and other developing and transition jurisdictions. Tax reform measures should include all relevant economic requirements without actually achieving one in favour of the other. Non-economic factors, unfortunately, affects both the level of total revenue collected and equity which warrants consideration.

#### **5.8.4 The Trade-off**

Developing countries cannot achieve economic and non-economic objectives without considering a trade-off between factors. South Africa should consider the theory of just income distribution, which can be traced back to Rawls (1971) and further developed by Dworkin (1981), Arneson (1989), Cohen (1989), Roemer (1993, 1996, 1998), Fleurbaey (1995) and Cappelen and Tungodden (2003), where it was held “ that with equal opportunities and respect for personal freedom, people should be held responsible for their accomplishments (Barth *et al.*, 2006:3).

These economists argued for the elimination of inequality beyond the control of individual taxpayers with the inequalities within the control of individual taxpayers being recognised as legitimate (Barth *et al.*, 2006:4). Following an empirical study Barth *et al.* (2006:20) concluded there are individuals' who would trade-off economic gains against fairness when considering a decision relating to tax evasion. Further Barth *et al.* (2006:14) stressed the importance of fair income distribution in the analysis of tax evasion. Bazart and Bonein (2014:83) dissected unfairness further into the vertical relationship between taxpayers and the public sector and a horizontal relationship between taxpayers themselves. Horizontal and vertical inequities, Bazart and Bonein (2014:84) found, either work together to increase tax evasion or work against each other thereby reducing the effects of tax evasion depending on the moral compass of the population. This unconventional theory may have an impact on revenue collection in South Africa.

With the plethora of factors discussed an obvious question would be: How would these factors benefit tax reform principles in South Africa?

#### **5.8.5 Benefits of Tax Reform**

A tax system that encourages taxpayers to fulfil their tax requirements believing they are being treated fairly would benefit any developing economy including South Africa. Viksne and Mazure (2011:227) highlighted the importance of informing and educating the population on the uses of tax revenue and its benefits to the population. Di John (2006:21) believes tax reform requires a

measure of social consensus that reform policies are in the general interest of its citizens. The willingness to pay tax is higher when taxpayers have confidence in the integrity of the government and the tax administration process (Awasthi & Bayraktar, 2014:2). A disturbing truth relating to South Africa has been corruption indignities that have flourished recently augmenting the perception of inequity, inefficiency and lack of good governance with Awasthi and Bayraktar (2014:2; Bird, 2008:16) highlighting the basis for establishing good governance being a corruption-free tax administration.

An improvement in wider governance relations can be the result of efficient, fairer and less corrupt tax systems (Cottarelli, 2011:4). Developing countries, particularly South Africa, need to raise awareness about the approximate size of its shadow economy and illustrate the downfalls of this phenomenon increasing responsiveness towards this concept resulting in a desire to pay taxes by the people. A further deterrent is high personal income tax rates which discourage work effort by reducing returns to below the productive labour rate (Oates & Schwab, 2004:13) introducing a further adverse effect on economic growth. Bird & Zolt (2005:1663) further highlight the influence high personal income tax rates have on capital investment location.

#### **5.8.6 The Shortcomings of Tax Reform Policy**

Tax structures in developing countries are administratively complex, non-responsive to growth and discretionary policy measures, raise limited revenue while introducing economic distortions, and inequitable when taxing individual and business income (Khalilzadeh-Shirazi & Shah, 1991:xvi). The importance of effective tax systems in South Africa and associated developing countries is affected by various factors.

South Africa needs to assess the tax capacity which is the ability of its citizens to pay tax and the contrasting ability of the government to effectively collect these taxes (Ahmad & Stern, 1989:1017). The tax structure should have a built-in mechanism which is able to generate growth in revenue through changes in gross income or output levels (Ahmad & Stern, 1989:1019). The method of raising taxes, particularly in developing countries such as South Africa may have profound effects on society (Sokoloff & Zolt, 2007:84). Taxes alter decisions as taxpayers strive to reduce tax liabilities; moreover taxes impose enforcement costs on governments coupled with compliance costs for taxpayers (Sokoloff & Zolt, 2007:84). The structure of taxes may unfavourably influence economic activities resulting in a larger informal sector should the tax liability imposed be particularly harsh (Sokoloff & Zolt, 2007:84; Bird, 2008:7) discussed in detail in Section 4.5.4. The actual calculation of the size of the informal economy, particularly in developing countries, remains elusive due to the diversity and unobservable nature of the activities (Kundt, 2017:2). The size and composition of the informal

sector is inherently linked to good governance issues which affect tax morale and compliance (Kundt, 2017:5) ultimately influencing equity principles and impacting on tax policy. Operating in the informal sector further impacts the contract between the State and the citizen which is based on the principles of “accountability, legitimacy and mutual trust, and encompasses a social norm of paying tax” (Kundt, 2017:7).

Tax policy reform must consider various other factors including the incidence of taxes (Section 4.7) which affects both the distribution of disposable income as well as political support for various public projects (Sokoloff & Zolt, 2007:84). The magnitude of taxpayer response to changes in marginal income tax rates is crucial to the formulation of appropriate tax and budget policies (Feldstein, 1995:551). Economic behaviour of taxpayers affect revenue collected with the compensated behavioural response affecting economic efficiency or deadweight loss resulting in short-run macroeconomic consequences on aggregate demand and employment (Feldstein, 2008:131). Taxes also have the ability to alter decisions made by taxpayers when modification to existing tax policy occurs (Bird, 2008:17). This effect reduces the efficiency with which resources are applied resulting in lower output which could affect the country as a whole (Bird, 2003:22). Policy analysis of alternative tax structures, particularly in developing countries, should involve a comparison of the revenue, deadweight loss and distributional consequences (Feldstein, 2008:132). Bird (2008:17) emphasised the requirement of marketing tax reform policies to all stakeholders to ensure effective implementation.

Effective tax policy requires the minimization of unnecessary costs by ensuring a broad tax base, low tax rates and the taxation of corporate income to prevent tax avoidance by retained earnings (Bird, 2003:25). An important consideration currently is the effectiveness of optimal tax theory in the South African context. Optimal tax reforms prove to be effective in minimising efficiency costs and take into account income equality by seldom endorsing a uniform tax rate (Thirsk, 1991:58). However, recent tax reforms have favoured broader tax bases at uniform rates resulting in a clash between theory and practice (Thirsk, 1991:58) although these have not resulted in a decrease in the inequality index in many jurisdictions. Uniform taxation has been known to deliver efficiency gains even though it may not achieve the goal of minimizing tax-induced efficiency losses (Thirsk, 1991:58). Developing countries have found the computational difficulties of implementing optimal taxation theory are substantial while the resultant payoffs are uncertain (Thirsk, 1991:58) resulting in a less than acceptable tax system.

Tax systems in developed countries derive their revenue from individual and corporate income taxes as well as consumption tax unlike developing countries where the majority of taxes are collected from levying consumption taxes (Avi-Yonah & Margoloth, 2007:4; Sokoloff & Zolt, 2007:85). Income taxes have a limited capacity to generate revenue in most developing

countries resulting in reliance being placed on indirect consumption taxes (Avi-Yonah & Margoliath, 2007:5; Thirsk, 1991:60).

However, South Africa relies heavily on personal income tax collection (more than one-third of its total revenue) in contrast with other developing nations. The tax statistics indicate reliance on consumption taxes consistent with other developing countries but the PIT to total revenue ratio is inconsistent with literature on developing countries. The dependence on individual taxpayers to contribute a substantial portion of the total revenue disregards historic economic principles and challenges the triad of equity, efficiency and fairness. In a country rife with unemployment and low economic growth revised economically principled tax policies could reverse these theories. Another important consideration for South African lawmakers is the factors that affect low economic growth which may be more political than economic. These political factors, unfortunately, influence economic decisions which control the adequate collection of revenue and the redistribution of income.

#### **5.8.7 Factors associated with low economic growth**

With liberalization comes the responsibility of assessing economic growth and the vital issue of redistribution of income in developing countries (Cobham, 2005). Political factors should not impede economic growth and good governance but should assist in satisfying the need for long term economic growth. Governments can impede economic growth due to weak governance where:

- large governments are more likely to run fiscal deficits during economic downturns, particularly where public spending is inflexible because of weak budgeting systems, reliance on earmarks, and high public employment
- the high rates of taxation needed to fund big governments can distort private activity, particularly if tax administrations are weak and thus not able to tap a broad tax base
- a large government presence in particular sectors may be accompanied by anticompetitive regulations on private sector participation
- government spending may be misallocated as a result of corruption or poor capacity, sapping productive resources from the economy

(Gray *et al.*, 2007:6)

Effective governance may alleviate one or more of these factors associated with poor economic growth while public spending and modest levels of taxation was advised by Gray *et al.* (2007:7)

to improve economic growth. Developing countries, in particular South Africa, due to their poor or non-existence levels of governance face a high risk of corruption (Bird, 2008:24; Dom & Miller, 2018:20).

Corruption, defined as the abuse of public power for private gain, is one of the major contributors to low economic growth, distortionary investment and the abuse of public funds (Dom & Miller, 2018:20; Dreher *et al.*, 2005:1; OECD, 2015:2). Corruption is believed to increase inequality among citizens with the World Bank (2001:25) identifying corruption as “the single greatest obstacle to economic and social development”. Corruption results in increased unemployment due to low economic growth which ultimately results in a smaller tax base without considering the effects of corruption on the shadow economy. Tanzi (1998:8) referred to corruption as:

intentional non-compliance, with arm’s length relationship from this behaviour for oneself or for related individuals’ abuse of public power for private benefit.

When corruption distorts the economic process and is associated with democratic politics, as in present day South Africa, citizens become sceptical of government. This accelerates the desire of citizens to join the underground economy as they believe their taxes are not being utilised adequately and efficiently (Bird, 2008:9; Carnahan, 2015:177). High corruption levels provide an incentive for citizens to access the underground economy which provides a cheaper alternative option (Katsios, 2006:76).

This cheaper, informal option was described by Saint-Supery Ceano-Vivas *et al.* (2010:6) as:

an individual condition but a process of income-generation characterized by one central feature: it is unregulated by the institutions of society, in a legal and social environment in which similar activities are regulated.

The shadow economy and corruption share a common trait as both result in untaxed revenue which is illegal, a trait South Africa can ill afford. Unfortunately, these impact the economic tax principles of equity and efficiency affecting total tax revenue adversely. Will major tax reforms decrease the size of the shadow economy and increase the tax base in South Africa is the question that needs to be answered. Katsios (2006:72) believes major tax reforms will succeed in stabilizing the shadow economy but not substantially decreasing its size. The high profits, strong personal relations and low cost of operating are additional factors that impact the size of and enhance the existence of the shadow economy. Other factors that inhibit economic growth and the size of the tax base include government spending, persistent efficiency distortions and excess regulatory burdens (Katsios, 2006:74). Higher taxes are harmful to economic growth

particularly when these produce distortions in environments where governance is ineffective (Bird, 2008:11; Gray *et al.*, 2007:14). Higher progressive tax rates have been found to be ineffective in raising additional revenue (Bird & Zolt, 2005a:1651; Cobham, 2005:20; Dom & Miller, 2018:14). Another suggestion by Colazingari and Rose-Ackerman (1998:458) was “a viable legal system of campaign finance” to limit the gains from corrupt deals. South Africa is a young democracy riddled with corrupt political and economic relationships that directly affect the lives of every South African. The formation of an independent judicial system, a free press, and private sector checks with efficient internal controls in the public sector (Colazingari & Rose-Ackerman, 1998:465) and an autonomous tax system with non-partisan members of staff could improve economic growth in South Africa. Fragile, young democracies need to create and enforce laws governing conflict of interest, financial enrichment and bribery risks (Colazingari & Rose-Ackerman, 1998:469). Everest-Phillips (2012:73) further highlighted the intensification of corruption occurred when:

the state became the vehicle for personal enrichment by the elite, and the state’s challenged legitimacy encouraged institutionalized criminality.

The effects of corruption on the economy have far-reaching implications. Corruption tends to limit foreign direct investment, decrease developmental rates, harm competition and facilitate the rise of the shadow economy in developing countries (Dom & Miller, 2018:20; Katsios, 2006:77). Taxpayers are influenced by the legitimacy of capable, honest, accountable and responsive governance. Taxes should be viewed as an investment into the State by taxpayers rather than as a burden that can be avoided or evaded. Unfortunately without:

political support to tackle evasion by powerful interests, the revenue authorities have instead directed their anti-tax evasion effort toward small taxpayers.

(Everest-Phillips, 2012:82).

When the privileged elite are allowed tax liberties, in the form of deductions and allowances, economic growth is adversely affected with a disastrous impact on employment levels. As the tax base is reduced further, tax rates increase further discouraging investment and employment opportunities. High tax rates are associated with low economic growth (Caballe & Panades, 2000:1) and are sustainable only when governments are honest (Katsios, 2006:78). Taxes distort the accumulation of capital, a prevalent obstruction to economic growth; does this advance the case for a revised tax system that is equitable and efficient?

### **5.8.8 Is the South African Personal Income Tax system equitable?**

Historically (Chapter 3) early economic thought and writings emphasized the importance of equity (Section 3.3) with these principles being reinforced by later economists (Section 3.5). The impact of equitable tax systems was enhanced by the need for efficiency (Section 4.3). An optimal mix would encompass both an equitable and efficient tax system a demand which is unfortunately impossible due to the trade-off between equity and efficiency (Auerbach & Hassett, 2005:3). Efficiency determines the economic growth of the country while equity provides social justice for the citizens (Avi-Yonah & Margoloth, 2007:4). The tax system should provide sufficient revenue to maintain sustained and inclusive economic development (Carnahan, 2015:169) reinforcing an effective, accountable and stable government.

Equity and efficiency of any tax system is affected by numerous economic and non-economic factors as has been demonstrated. Unfortunately due to historical differences in taxing dissimilar types of taxpayers in South Africa (Section 5.4), a review of the revenue collection data (Section 5.5), the reports by the two Tax Commissions (Section 5.7) and the challenges faced by a developing country (Section 5.8) it is difficult to conclude that the personal income tax system in South Africa is equitable.

### **5.9 Conclusion**

South Africa is experiencing a period of low economic growth, high unemployment and general distrust in the ruling government by taxpayers. The Minister of Finance in his Budget Review (National Treasury, 2017:38) stated:

The payment of taxes is a legal obligation, but the effectiveness of the tax system relies to a large extent on the willingness of citizens to contribute. This cannot be taken for granted given rising public concerns about corruption, wastage of public funds and inefficiencies in service delivery. A marked decline in the culture of tax morality would have negative effects on the public finances and be exceptionally hard to reverse.

This view was likewise held by Everest-Phillips (2012:72) where he commented on the role of taxation affecting the legitimacy of the State based on consent of taxpayers demonstrated by tax morale and the inherent willingness to pay tax (Carnahan, 2015:181).

Although there are equity, efficiency and fairness concerns related to the present tax system there are other economic and non-economic factors that affect these primary factors. The voluntary compliance method, coupled with the increased complexity of the tax system tends to influence taxpayer behaviour (Carnahan, 2015:173) ultimately impacting on economic

decisions. The South African tax system is challenged by a growing informal economy due to the lack of formal employment opportunities and a limited tax base that is shrinking. However, total revenue required by the State is increasing resulting in the present tax base having to bear the additional tax burden. In the current situation, personal income tax has been increased to accommodate the low revenue yield from other forms of taxation. These higher personal income tax rates further encourage tax evasion among the existing tax base who believe the exorbitant tax rates are unacceptable. The extent of tax evasion according to Everest-Phillips (2012:72) provides a beneficial indicator of the quality of governance. Unfortunately there are no formal quantitative studies relating to the extent of tax evasion (Umar & Tusubira, 2017:113) with its appropriateness being considered acceptable; in most instances, where the government is perceived to be corrupt and tax revenue is misused (Ross & McGee, 2012:17). Alm and Torgler (2012:32) highlighted the importance of factors such as social norms, moral sentiments and tax equity that affect taxpayer compliance. For tax equity to be achieved, taxpayer compliance is of paramount importance. High levels of tax evasion may offset equity even though tax legislation has built-in equity principles. A large informal economy results in lower revenue collection by the State and subsequent distortion of official indicators influencing areas of growth, competitiveness and income redistribution. A significant setback associated with developing economies is the inability to measure, monitor or evaluate the costs associated with the informal economy (Avi-Yonah & Margoloth, 2007:4; Carnahan, 2015:177). However, the OECD (2015:1) is of the opinion that transparent, fair and efficient tax systems are central to sustainable growth in developing countries.

The universal characteristics associated with a good tax system are fairness, equity, simplicity, certainty, stability and acceptability by taxpayers (Bird, 2008:3; Steenekamp, 2012:48). Injustice and discriminatory tax systems result in reduced total revenue being collected. The 2018 increased PIT marginal tax rate of 45% falls above the OECD standard top PIT rate of 38,1 percent (OECD, 2019:4), increasing the tax burden for the existing small tax base whereas the top CIT rate is still well below the PIT marginal tax rates (Steenekamp, 2012:49) encouraging tax reducing measures. Progressive personal income tax systems have, however, not had the desired effect of reducing inequality in developing countries due to the high costs and low gains associated with this policy (Bird & Zolt, 2005a:1694).

Developing countries generally require more revenue than developed countries but face challenges in maintaining the required level of revenue due to global tax competition that encourages capital mobility (Bird, 2008:17; Everest-Phillips, 2012:73). Developing countries should, therefore, employ favourable tax rates that ensure an equitable, efficient and fair tax

system that encourages compliance by taxpayers, reduces tax avoidance and evasion and achieves the relevant revenue goals (Bird, 2008:23).

The ever changing South African tax legislation provides no stability for the domestic or international investor. This uncertainty encourages taxpayer migration towards more favourable and stable countries with reliable tax policies (Bird, 2008:17; Carnahan, 2015:179) a phenomenon South Africa could least afford.

Ideal tax reform policies are unfortunately not accessible, as all policy changes will involve a trade-off between economic principles due to the influence of economic and non-economic factors as has been illustrated. The following chapter analyses tax reform policies globally concentrating on transition and developing jurisdictions including those adjacent to the South African borders compelling a review of the current tax laws a necessity if domestic and foreign investment is to be promoted.

## **CHAPTER SIX: ALTERNATE TAX SYSTEMS**

### **6.1 Introduction**

The primary goal of this research analysed the principles of equity, its origins and the significance of an equitable tax system as it pertains to individual tax burdens in South Africa. A study of equity and its associated concerns (as discussed in Chapter 4) with the analysis of the South African tax system as it relates to personal income tax (discussed in Chapter 5) is incomplete without recommendations and analyses relating to contemporary tax systems that have been implemented in an attempt to enhance the principles of equity, efficiency and fairness in transition and developing countries. This chapter explores the secondary objective number four of analysing alternative tax systems employed by fundamentally developing and transition countries to achieve the desired objective of equity or perceived equity.

The primary aim of any government when executing tax reform processes are:

1. to increase the part of revenue mobilized to public funds and
2. to encourage the growth of the economy to raise standards of living

(Carnahan, 2015:169; Krivka, 2006:73).

Secondary objectives of extracting revenue from the private sector include the allocation of the cost of government in some fair way without increasing inflationary pressure to ensure political stability (Bird & Zolt, 2005a:1630) particularly in developing economies. However, tax experts and economists maintain the most important goals of levying tax involve the collection of sufficient revenue in an equitable and efficient manner, goals which are often mutually reinforcing but not always (Gray, 1989:2). An efficient tax as discussed in Section 4.3, should collect the desired amount of revenue with minimal economic distortions on savings, investments, production and individual labour (Bird, 2008:4; Gray, 1989:2). The concept of equity which is often used interchangeably with the concept of fairness is related to the ability to pay but is often contradictory with the other two goals of maximizing revenue collection and efficiency (Gray, 1989:3) (Sections 4.4 and 4.5). Although economists and politicians agree that taxes should be efficient, simple and fair, the concept of fairness seems to form the basis of the disagreement (Hall & Rabushka, 1995:23; Umar & Tusubira, 2017:115).

Concepts of fairness differ depending on the source used but its most common interpretation affirms the same or equal treatment of all taxpayers (Hall & Rabushka, 1995:26). Current

literature often defines this concept as the principle of horizontal equity (Section 4.4.1), a topic that has been argued at great length by economists, with vertical equity (Section 4.4.2), being defined as the treatment of unequals concentrating on the progressiveness of the tax system while fairness (Section 4.5) denotes how, why and when tax should be paid although this is a highly debated view (Chittenden & Foster, 2008:7). Fairness incorporates the social perception of the tax system and traverses the realms of economics and social behaviour. Regardless of which definition is employed fairness requires all citizens be held to a fixed, clear and reasonable standard agreed by the majority in a democracy (Armey, 1996:31).

Armey (1996:30) believed the current tax laws have abandoned the notion of equity and fairness (discussed extensively in Section 4.5) through the numerous loopholes and deductions that are found within the tax laws. These inconsistencies result in billions of tax revenue being lost as affluent taxpayers gain from special favours and tax breaks offered to certain taxpayers' only (Armey, 1996:31). The basic form of tax laws have evolved to levels that are "mind-numbingly difficult to discern" (McCaffery, 2002:4). These convoluted tax laws have resulted in a complicated, inefficient and unfair tax system (McCaffery, 2002:3).

Further impediments when exploring differing tax reform ideas would include the decision to tax consumption or income (Section 4.3.3), an analysis of compliance measures relating to progressive and proportional tax systems (Section 4.6) and their related setbacks. The South African tax system (discussed in Chapter 5) analysed the equity and revenue collection aspects of the current progressive personal income tax system employed. With the existing small tax base, the search for optimal taxation principles would be advantageous.

An optimal tax system (Section 4.5.1) would ideally be the ultimate goal of lawmakers however the equity versus efficiency dilemma will always be present (Auerbach & Hassett, 2005:2–3). Difference in opinions about various tax reforms often emerge concerning the appropriate weighting to be placed on equity and efficiency. Two issues dominate this argument: the progressive tax proponents believe that marginal tax rates should be progressive while the detractors believe the equity benefits from significantly graduated tax rates do not justify the costs in efficiency (Auerbach & Hassett, 2005:2–3). An additional impediment faced by tax authorities is the increased mobility of investments, factors of production, goods and services (Norregaard & Khan, 2007:4). Certain governments have responded to these issues by adopting tax policies that minimize costs while retaining or improving the tax base (Norregaard & Khan, 2007:5).

In the search for an effective tax system many proposals were advanced which may or may not satisfy the basic goals of a tax system in a developing country. A tax system should function as

a stabilizer for economic growth while raising enough revenue (Carnahan, 2015:169; Martinez, 2004:415) to ensure the smooth functioning of the State. The ultimate goal of an ideal tax system would incorporate economic effectiveness, equity, administrative simplicity enhanced by a transparent, competitive and predictable set of laws (Krivka, 2006:73; Umar & Tusubira, 2017:110), factors which are impractical. This potential setback resulted in economists experimenting with various concepts in their quest to attain the most favourable tax system resulting in subtler versions of an alternative tax system.

This chapter analyses alternate tax systems employed by developing and transition countries to achieve greater equity, efficiency and simplicity with special emphasis on the flat tax system. An overview of alternate personal tax systems is followed by a comprehensive discussion of flat tax systems, their implementation and consequences and the policy implications of variations of this with specific mention of the dual tax system.

## **6.2 Alternate Personal Income Tax Systems**

The primary reason for tax reform has always been to enact a simpler, fairer and economically efficient tax system that is globally competitive (Nellen & Porter, 2016:7). Fair tax systems bridge the gap between socioeconomic equity and opportunity as tax systems represent a critical interface between the state and its citizens (Forstater, 2018:3; Jewell *et al.*, 2015:7). Tax systems should ideally focus on minimizing the “excess burden” otherwise referred to as economic losses from taxation in their endeavour to attain an optimal tax mix (Castanheira *et al.*, 2012:2) that benefits all its citizens. However, many countries prefer to maintain a non-optimal tax system as this serves their redistributive needs without complying with the relevant levels of equity (Castanheira *et al.*, 2012:2). Redistribution of income tax is associated with distortion of incentives but the resultant efficiency losses need to be evaluated against any potential progress in the fairness of redistribution (Fleurbaey & Maniquet, 2006:55). Nonetheless, tax systems exist which are neither economically efficient nor successful at redistributing incomes (Castanheira *et al.*, 2012:2).

Developing countries are particularly susceptible to inequitable and inefficient tax systems due to other underlying factors that impact revenue collection. The basic structure of tax systems in developing countries is different to their developed counterparts (Avi-Yonah & Margoloth, 2007:4). Personal tax systems in developing countries are plagued by minute tax bases with a proliferation of the shadow economy. The shadow economy can be described as “all market-based legal production of goods and services that are deliberately concealed from public authorities...” (Torosyan & Filer, 2012:2). The shadow economy is analysed in detail in Chapter 4, Section 4.5.4 and its effects on developing countries in Chapter 5. .

Gorodnichenko *et al.* (2007:1) suggested the increase in tax evasion could be directly linked to high personal income tax rates, especially in emerging markets. In most jurisdictions, the most prevalent single tax is personal income tax. Personal income tax rates affect public opinion influencing revenue collection either positively or negatively (Dell'Anno *et al.*, 2007:254). It might be argued that high personal income tax rates tend to affect public perception negatively which could result in an increase in tax evasion mechanisms ultimately influencing total revenue collection. A further dilemma faced by developing countries relating to high marginal tax rates result in substantial efficiency losses (Section 3.3) adversely affecting redistribution policies (Bird & Zolt, 2005a:1652; Carnahan, 2015:173; Umar & Tsubira, 2017:108).

With the ultimate aim of collecting maximum revenue, a fair tax system remains an indispensable component of tax legislation enhancing taxpayer morale and voluntary compliance (Martinez, 2004:416). High personal tax rates are usually associated with negative effects on the real economy (Gorodnichenko *et al.*, 2007:1) and a perception of unfairness which results in diminished levels of total revenue collected (Martinez, 2004:416). The incentive for taxpayers to evade taxes is substantially greater when the tax burden is higher prompting an increased shadow economy adversely affecting total tax revenues collected by the discus. Other reasons for evading tax include simplicity of not paying tax, perceived corruption of the government in power, and an unfair tax system (Yew *et al.*, 2015:63–64).

The importance of administering a just, non-discriminatory impartial tax system is paramount especially when total revenue collection needs to be enhanced while adhering to equity and efficiency principles. Alternate tax systems should provide the basic economic requirements while ensuring effective implementation especially in developing countries.

### **6.2.1 Impartial Tax systems**

The historical economic tree, dissected in Chapter 3, analysed the birth and growth of economic tax principles highlighting the desire for economists to achieve an ideal tax mix that would satisfy the basic economic and social principles. A non-discriminatory tax system was the ultimate goal resulting in a variety of suggestions. As defining a n unbiased tax is almost impossible the search for this definition led to alternate approaches.

The argument for alternate, impartial tax systems was initiated by Mill when he observed that taxation of larger incomes at a higher percentage could be regarded as a penalty on “people for having worked harder and saved more than their neighbours” (Mill, 1973:487). Mill (1973:487) further remarked “It is not the fortunes that are earned, but the fortunes that are unearned that is for the public good to place under limitation” (Pierce, 2015:31).

Traditionally fair income tax models focussed on earnings only, however a move to include non-income earnings in the tax base was also forwarded (Ooghe & Peichi, 2015:2025). In 1920, Pigou advanced the notion of subsidising or taxing externalities that exist to promote efficiency subsequently differentiating the tax-benefit system on the basis of these tags (Ooghe & Peichi, 2015:2025). Externalities, discussed in Section 3.7.5, is defined as something that is produced but the effects of which are not taken into account which could be positive resulting in social and revenue gains or negative resulting in private and social costs. Gahvari (2014:525) recently described the Pigouvian tax as a tax levied on the externality that is equal to the marginal social damage caused by the said externality. The desire to include other non-income sources in the tax equation led to further research by economists.

Subsequent to these early suggestions, Ooghe and Peichi (2015:2024–2025) expanded the principle of fairness and efficiency, as related to tax systems, based on income and non-income factors under partial control where partial control was described as “each factor is a specific mixture of unobserved ability (randomly drawn by nature) and effort (chosen by individuals who differ in tastes)”.

Traditional economists believed the welfare function determines the effect of a policy decision on an individual’s well-being and extrapolates an aggregate judgement based on this information (Kaplow & Shavell, 2003:3). This classic welfare function was used to satisfy the Pareto Principle (discussed in Section 3.7.2) which required compensation to individuals for differences in their abilities. In summary: the Pareto principle also referred to as the 80/20 rule, stated that 20 percent of the invested input is responsible for 80 percent of the output (Ivancic, 2014:635). Ivancic (2014:638) further disseminated the 80:20 Pareto principle, in a general sense, into effectiveness and efficiency components with effectiveness representing the extent to which planned activities were realized and achieved with efficiency being the relationship between the results and resources used. Extrapolating the Pareto principle to tax theory would result in a transfer from individuals who are better off to those who are worse off in outcomes caused by differences in abilities i.e. individuals with the same preferences exerting the same effort (Ooghe & Peichi, 2015:2025). In some measure, the Pareto principle would satisfy the redistribution component of tax theory but other economic measures may be lacking.

In their search for a just tax system, various economists experimented with different bases of taxation resulting in the toss-up between taxing income (Section 3.3.3) or taxing consumption. Consumption taxes are designed to capture all consumption in the economy with the amount of consumption being derived from income (Weisbach, 2000:603). Income, as defined by Weisbach (2000:603), is the amount consumed during a given period by a consumer including any variation in savings. Consumption would then amount to income less savings. Further

deliberations relating to an impartial method of taxation centred on the proportionality or progressivity of either income or consumption taxes.

The debate around proportional versus progressive tax systems was characterized by Seligman (1894:8) where the distinction was made by referring to progressive tax systems as graduated with the graduation being upward. Proportional taxation was initially defined as a constant, identical tax rate on all taxed items (Seligman, 1893:8). The theory pertaining to progressive tax systems argued for equal sacrifice where more affluent taxpayers are taxed relatively more than the less affluent taxpayers justifying the theory. However, Seligman (1893:237) highlighted the meaning of equal in the economic sense as:

When economists speak of equal sacrifice they mean relatively proportional sacrifice. When equality of taxation is mentioned it does not mean that the identically same amount should be taken from each taxpayer for that would involve the grossest inequality.

The term equal taxes invokes the idea of a proportional tax. Blum and Kalven (1952:419) noted under a proportional tax system an individual would pay the same rate on income earned irrespective of total income whereas with a progressive tax system the individual is taxed at a higher rate as income increases. The objections towards a progressive tax system (Section 3.6.4) included tax laws of “almost impenetrable complexity” and taxes which affect the minority of voters although the majority of the population are allowed to vote (Blum & Kalven, 1952:435). Progressive tax systems are known to reduce the economic productivity of taxpayers affecting incentives to work, invest and consume (Blum & Kalven, 1952:437; 442; Diamond & Saez, 2011:1). Although Blum and Kalven (1952:486) argued for the redistributive nature of progressive tax systems they accepted the lack of discussion by economists relating to equity issues of progressive tax systems.

The following tax systems have been identified as contemporary tax reform structures that differ from the existing South African progressive personal income tax situation. Tax systems in developing countries were largely historical remnants which advocated for progressive tax systems with this view being revised over time (Bird & Zolt, 2005a:1648; Dom & Miller, 2018:14). Correspondingly tax reform strategies tend to follow political norms rather than economic principles (Bird & Zolt, 2005a:1651) with economic thought favouring broad based, low rate tax reforms that respect both efficiency and distributional obligations in developing countries rather than a highly progressive tax system (Bird & Zolt, 2005a:1651; Dom & Miller, 2018:16). Although there is no perfect tax reform method that can be implemented globally

(Dom & Miller, 2018:18), each of the following demonstrate their advantages and disadvantages.

### **6.2.2 The X-Tax**

The deliberation between income and consumption taxes continued when McCaffery (2002:97) proposed replacing the “inconsistent income and ineffective estate taxes with a single, consistent, progressive spending tax”. McCaffery (2002:97) further suggested that borrowing should be included as income; there should be unlimited deductions for contributions to savings accounts while capital gains tax, donations tax and estate duty should be repealed. This progressive consumption tax, sometimes referred to as the “X tax”, is believed to benefit the economy as it falls on consumption rather than labour and production (Cheney, 2012:30). Accordingly a consumption tax does not actively discourage investment and savings resulting in economic growth.

There are various versions of the X-tax: Marron suggested a variation of value-added tax with the final tax bill being paid by the consumer resulting in a regressive tax falling disproportionately on lower income groups (Cheney, 2012:30). Another approach forwarded was the Bradford X Tax which taxes workers on wages only not on interest, dividends and capital gains (Cheney, 2012:30). The McBride X Tax, a further variant, advocates taxing all businesses under the same regime with the same rates and definitions of costs and receipts but scrapping all corporate and individual taxes and starting over with a universal tax code (Cheney, 2012:30).

The universal tax code would tax individuals and corporate entities at the same level which would eliminate the unfairness of passing business income through a series of exemptions and deductions. An option proposed by Bankman and Schler (2005:5) introduced a flat-tax/X-tax based on taxing businesses on gross receipts less wages with the costs of inputs being immediately deductible. Individuals would be taxed at a progressive rate with the top individual rate being equivalent to the business rate and self-employed individuals being taxed as businesses (Bankman & Schler, 2005:5). Financial transactions and instruments for either businesses or individuals are not subject to tax under the Bankman and Schler, (2005:5) flat-tax/X-tax system.

This debate around the most favourable practical tax system continued with the fair tax proposition.

### **6.2.3 Fair Tax**

Boortz and Linder (2005:75) advocated a 'Fair Tax' that would replace all current taxes with a single-rate personal consumption tax on new goods and services only. The Fair Tax would abolish all taxes on income but consumers would pay an embedded 23 percent consumption tax on all retail goods and services that would exclude all used or previously owned items (Boortz & Linder, 2005:76). To eliminate the extra tax burden on lower income households Boortz & Linder (2005:79) proposed a prebate (an advanced rebate) that every household will receive to cover the costs of basic necessities.

The various advocates of a fair tax system do not necessarily promote a flat tax. However, the common belief that a simple tax is a good tax led to the acceptance that multiple tax brackets lead to complex tax systems which inspired the emergence of the so-called flat tax (Nicodeme, 2007:138).

Brown and Gale (2012:7) characterised 'ideal' income tax reform as creating a system with a broad base that taxes all sources of income at the same rate to create low statutory tax rates. While broadening the tax base will require restricting allowances and deductions and limiting preferential tax rates, credits and deferrals to ensure the taxation of all sources of income (Brown & Gale, 2012:7). Tax expenditure reforms also have the potential to ensure a fairer, simpler and more efficient tax system resulting in an academic debate consumed economists through many eras and eventually led to the flat tax proposal by Hall and Rabushka in 1985 (Nicodeme, 2007:138).

### **6.2.4 Overview of Just Taxes**

The concept of fair or just taxes has been around for as long as taxes have been. However, the method of deducing what a fair tax is has proved rather more difficult (Martinez, 2004:413). The concepts of horizontal and vertical equity need to be addressed together with what economists refer to as an optimal tax system (Sections 4.4 and 4.5). A reasonable burden should tax income or consumption, not both, with the toss-up between the taxation of labour income and investment income being problematic (Kleinbard, 2010:42). Taxing investment income may be observed as unfair as this is probably income that has been subject to tax in some form previously. A progressive or flat rate of tax is also challenging and is contingent on a number of other factors. A fair tax does not necessarily imply a flat rate of tax but could be a tax that is non-discriminatory against equal income earners (Section 4.5).

The continuing debate regarding popular tax reform systems has resulted in the adoption of revised income tax systems particularly in developing and transition countries. Of the tax reform

proposals, the flat tax has proven to be the most popular alternate tax system which has been implemented in numerous jurisdictions around the world. This study focussed predominantly on flat tax systems due to the number of transition and developing countries that have converted their existing tax systems to a version of the flat tax. Equity and efficiency considerations together with the benefits and shortcomings of this tax system are discussed.

Certain Nordic countries, however, adopted a dual income tax system, where capital and labour income are recognised as different entities and taxed as such (Kleinbard, 2010:43). A discussion of flat tax systems will be followed by an overview of the dual tax system.

### **6.3 The Flat Tax**

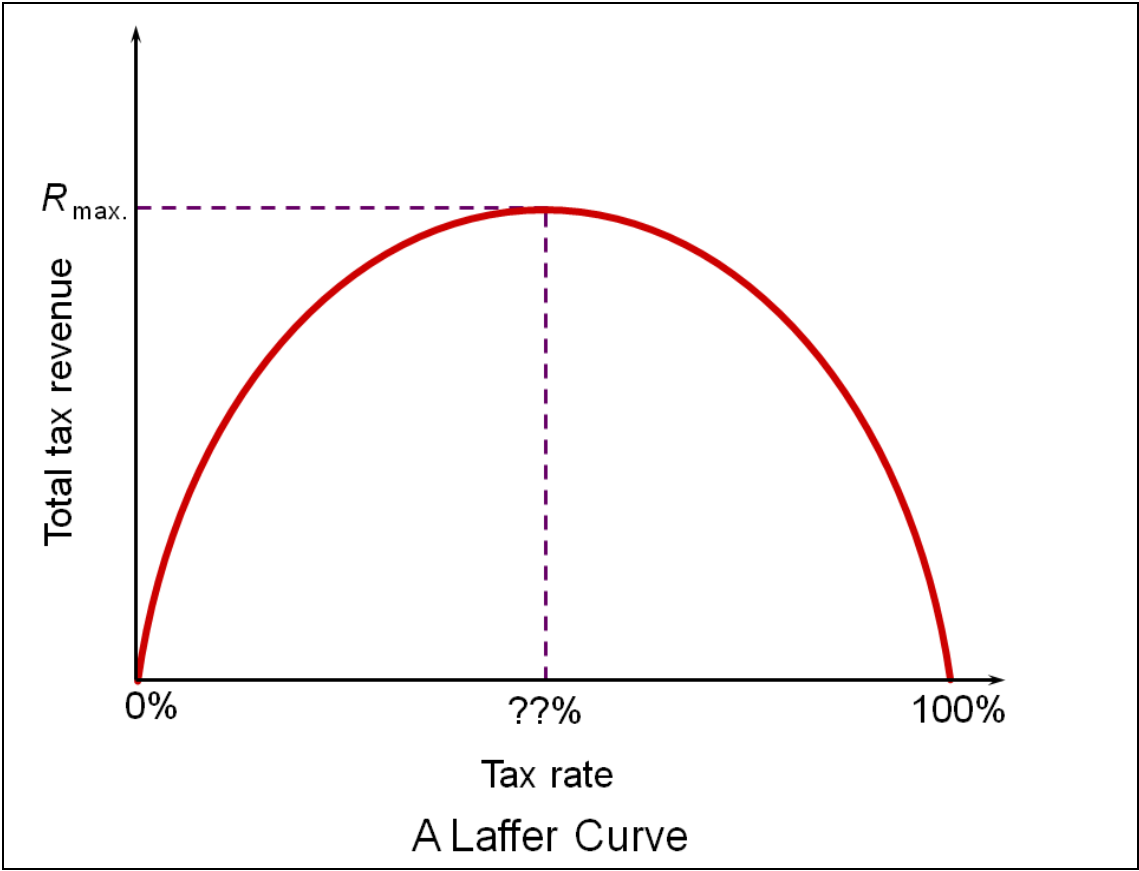
Two different approaches exist, the first being the conventional tax on income and investments commonly referred to as the comprehensive income tax and a cash-flow tax which is a tax based on consumption. Consumption is income less savings differentiating a consumption tax from an income tax by the treatment of savings or investments (Gale, 1999:155). An income tax taxes investments twice, once when earned and when interest is earned on the capital amount whereas a consumption tax taxes savings only once (Gale, 1999:155). However, consumption taxes, although seemingly simple, appear in numerous forms.

Hall and Rabushka first introduced their consumption based flat tax model in 1985 which excluded all capital or interest income and taxed only business and employment income (Blazic, 2009:2). An ideal tax rate that maximises revenue collection is essentially much sought after by any State and economists' base tax rate calculations on a principle referred to as the Laffer Curve which indicates the maximisation of revenue collection.

#### **6.3.1 Laffer Curve**

Resurgence of the taxation interpretations by historical economists can be credited to proponents of the flat tax who believed the implementation of this tax would follow the principles of the Laffer Curve. The relationship between the tax rate and the amount of revenue collected was best explained by Dr Arthur B. Laffer in 1979 where the trade-off between tax rates and tax revenues was portrayed (Grecu, 2004:5; Laffer, 2004:2). Although the relationship between tax rates and revenue is commonly known as the Laffer Curve, Laffer (2004:1–2) credited Ibn Khaldun (Section 3.3.4.2), a fourteenth century Muslim philosopher and the more recent Keynes (Section 3.7.7) with the theoretical discovery of this relationship. Laffer described the concept as collecting no revenue at zero and a hundred percent tax rates (Figure 6-1). However, the phenomenon was described as the result of two effects, the first arithmetic effect which is static i.e. if the tax rate is lowered the amount of revenue received will be proportionately lower and

the second economic effect which recognizes the positive effect that lower tax rates have on employment and output (Laffer, 2004:2). When the arithmetic and economic effects of tax rate adjustments are combined, the effect on total revenue is reduced (Laffer, 2004:2). The Laffer principle was portrayed graphically demonstrating the trade-off between tax rates and tax revenue (Figure 6-1). The curve suggests that tax revenue increases more steeply at low levels of taxation with the revenue increasing at a decreasing rate as tax rates increase (Grecu, 2004:5). The point  $R_{max}$  (Figure 6-2) represents the maximum amount of revenue which can be collected. Any further increase in tax rate will result in a decrease in the amount of revenue collected as demonstrated by Figure 6-3.



**Figure 6 - 1: Laffer curve**

(Source Laffer 2002:2)

According to the Laffer curve, the identical amount of revenue is collected at two points on the graph, once at a low tax rate and the other at a high tax rate. However, as Fullerton (1982:6) pointed out, Laffer did not offer percentages or tax rates in the graph limiting its benefits. Although the Laffer curve demonstrated what happened when the arithmetic and economic effects collide, it cannot predict whether a change in tax rate will increase or decrease tax revenue (Fullerton, 1982:3). The Laffer analysis does, however, offer an explanation relating to

the collection of revenue in two different ways: firstly by collecting a high tax from a narrow base i.e. a small portion of the population or by lowering the tax rate and collecting revenue from a larger base (Greco, 2004:5).

The Laffer curve theory ignored other economic factors that influence tax revenue: the type of tax system in place; economic growth; the present tax rate/s; tax loopholes; the underground economy and present productivity levels (Fullerton, 1982:6). The progressive tax system raises a barrier against working extra hours, reinvesting and saving which can be resolved by using the Laffer curve analysis and lowering tax rates (Greco, 2004:5). However, when assessing tax policy the possible effects on the Laffer curve should be considered together with the equity-efficiency trade-off.

Compliance by taxpayers cannot be accurately assessed due to the many social factors affecting it. Without accurate compliance data tax revenues become difficult to estimate rendering the effects of the Laffer curve suboptimal. Although various economists (Chapter 3) published their findings relating to the relationship between tax rates and the required tax revenue this information was underutilized until two American economists Hall and Rabushka formulated their alternate tax plan.

### **6.3.2 History of Flat Taxes**

The concept of proportional taxation was first introduced in early economic (Section 3.3.1) and theological history (Section 3.2.2). The argument relating to proportional taxation versus progressive taxation was advanced by Marx who encouraged Socialist ideals, one of them being a progressive tax system (Section 3.6.4). Most modern countries adopt some sort of progressive taxation although democratic not socialist principles are practiced.

A new wave of interest in proportional taxation techniques was sparked by Hall and Rabushka when they forwarded the blueprint of consumption based flat tax.

### **6.3.3 The Hall-Rabushka Flat Tax**

The flat rate tax concept based on proportional taxation recognised by early economists was revived by the American economists Hall and Rabushka in the 1980s when they presented a consumption type tax system which achieved some of the advantages of a value-added tax while addressing concerns that consumption taxes impose a substantial tax burden on lower income groups (Gale, 1999:155). The Hall-Rabushka flat rate tax applied to both businesses and individuals with all income being divided into either business income or wages i.e. individual income including salaries and retirement benefits (Hall & Rabushka, 1995:55). The tax structure

proposed was precisely defined and coherent and was summed up as a cash-flow tax on business and a tax on employment income both levied at the identical, single tax rate (Keen *et al.*, 2008:713). The hallmarks of the Hall-Rabushka tax was the removal of taxation on all investment income which they argued would stimulate supply-side economics (Vionea & Mihaescu, 2009:20).

Business tax, which covered all businesses not just corporate structures, was proposed at the low rate of nineteen percent after the deduction of wages, pension contributions, material costs and capital investments (Gale, 1999:155; Hall & Rabushka, 1995:55). Individuals were taxed per household and assessed at nineteen percent on wages and pension benefits above an exemption of \$25 500 for a family of four when this tax was proposed in 1995 (Gale, 1999:155; Hall & Rabushka, 1995:55). Families pay no tax on interest, dividends or capital gains as these are taxed at the source by the business tax (Hall, 2005:2).

The later 2004 revision of the flat tax by Hall and Rabushka identified the need for a higher exemption for a family of four where the exemption rate was increased to \$41 000 (Hall, 2005:2). According to this proposal a family of four earning less than \$41 000 per annum would pay no tax at all. No other income was taxable and no other deductions were allowed (Gale, 1999:155). The theoretical or academic form of this type of consumption tax would abolish any forms of double taxation including inheritance and death taxes (Heath, 2006:11). This would, according to Heath (2006:11) result in an efficient, transparent, simple and fair tax as advocated by Adam Smith.

Hall and Rabushka (1995:55) argued that taxing consumption would strip the system to basics as individuals either spend or invest. With consumption being a measure of income less investment this system eliminated the issue of double taxation while encouraging savings ultimately resulting in economic growth. This method of taxation embodies the basic administrative principle that “income should be taxed exactly once as close as possible to its source” (Grecu, 2004:10; Hall & Rabushka, 1995:52). The basic concept of the flat tax was highlighted using the equality of tax rates since different tax rates for different forms of income encourage tax avoidance and tax evasion (Hall & Rabushka, 1995:53).

### **6.3.3.1 Benefits and Shortcomings**

The benefits of the flat rate tax include the provision of incentives for capital formation through investment write-off, the simplicity of this tax system and its uncomplicated administrative process (Hall, 2005:5).

Although Hall and Rabushka identified the consequence of this action may reduce the tax burden for lower and higher income groups at the expense of the middle income earners, they did not calculate the effects of inequality (Vionea & Mihaescu, 2009:22). Another concern as regards the introduction of the Hall-Rabushka flat tax related to the principles of equity and efficiency. Peichl (2009:25), in a simulated study, concluded that the equity-efficiency trade-off can be overcome in the long run when considering personal flat rate consumption taxes. The principles of equity and efficiency were further analysed.

Peichl (2009:25) noted the effect of combining an individual flat tax with a business income flat tax at the identical rate increased inequality (a measure of richness) at the expense of middle-class taxpayers while producing greater efficiency effects. Earlier Zelenak (1999:209) analysed the sources of inefficiency and highlighted two distinct distortionary measures relating to an income tax: a labour-leisure distortion and a present consumption-future consumption distortion. The consumption tax was found to eliminate the deadweight loss effects of present consumption -future consumption distortion but not the labour-leisure distortion (Zelenak, 1999:209).

Calegari (1998:689) highlighted the claim by proponents of the Hall-Rabushka flat tax idea where they maintained elimination of the United States income tax and replacing it with the flat tax would:

increase personal savings and business investment, reduce interest rates and compliance costs, and curtail incentives and opportunities for tax evasion and tax avoidance.

The flat tax idea was further evaluated with Zelenak (1999:209–211) establishing a consumption based tax is not superior to an income based tax and a flat tax with no exemptions would be more efficient than the Hall-Rabushka tax with a basic exemption. The issue of consumption versus income based tax is a controversial issue with consumption based taxes losing popularity.

### **6.3.3.2 Tax Returns**

Hall and Rabushka declared individuals and businesses would not be able to escape taxation as there were no provisions for exclusions, deductions and tax credits (Calegari, 1998:690). The low rate of tax, nineteen percent, was professed to raise the same revenue as the tax system at that time with tax on families being fair and progressive, as those below the exemption level would pay no tax (Hall & Rabushka, 1995:52).

The tax system was simple and easy to understand which helped fulfil the relevant economic criteria of equity and efficiency while collecting the required revenue to finance government spending. However, the equity-efficiency trade-off was explored much later by economists.

Hall and Rabushka (1995:59–62) further simplified the administrative element of the tax system by designing the postcard tax return, Form 1 (Figure 6-2) and Form 2 (Figure 6-3) below, which only required a few elementary calculations.

Hall and Rabushka (1995:59) proposed the following tax form for individual taxpayers as shown in Figure 6-3 below. All income including any earnings from pension and retirement benefits comprise gross income with the personal allowances being split depending on marital status (Line 4) and dependent status (Line 5) resulting in taxable income. This taxable income is taxed at a flat rate of 19 (nineteen) percent. The individual Wage-Tax form comprises 12 lines while the business tax form (Form 2, Figure 6-3) comprises 10 lines simplifying tax returns for both individuals and businesses and taxing all income at a flat rate of 19 (nineteen) percent.

Figure 6-3 (Business tax form) allows for the provisions of any loss that may be created by expensing all capital equipment in the year it was purchased (Hall & Rabushka, 1995:97). This is referred to in line 6 as “carry-forward” with lines 6 to 10 illustrating the carry forward process which earns interest at the rate of 6 percent (Hall & Rabushka, 1995:97).

<b>Form 1</b>		<b>Individual Wage Tax</b>		<b>1995</b>	
Your first name and initial (if joint return, also give spouse's name and initial)		Last name		Your social security number	
Home address (number and street including apartment number or rural route)				Spouse's social security number	
City, town, or post office, state, and ZIP code		Your occupation			
		Spouse's occupation			
1	Wages and salary	1			
2	Pension and retirement benefits	2			
3	Total compensation (line 1 plus line 2)	3			
4	Personal allowance				
	(a) o \$16,500 for married filing jointly	4a			
	(b) o \$9,500 for single	4b			
	(c) o \$14,000 for single head of household	4c			
5	Number of dependents, not including spouse	5			
6	Personal allowances for dependents (line 5 multiplied by \$4,500)	6			
7	Total personal allowances (line 4 plus line 6)	7			
8	Taxable compensation (line 3 less line 7, if positive; otherwise zero)	8			
9	Tax (19% of line 8)	9			
10	Tax withheld by employer	10			
11	Tax due (line 9 less line 10, if positive)	11			
12	Refund due (line 10 less line 9, if positive)	12			

Figure 6 - 2: Individual Wage Tax.

(Source: Hall & Rabushka, 1995:59)

Form 2		Business Tax		1995	
Business name			Employer identification Number		
Street address			County		
City, state, and ZIP code		Principal product			
1	Gross revenue from sales	1			
2	Allowable costs				
	(a) Purchases of goods, services, and materials	2a			
	(b) Wages, salaries, and retirement benefits	2b			
	(c) Purchases of capital equipment, structures, and land	2c			
3	Total allowable costs (sum of lines 2(a), 2(b), and 2(c))	3			
4	Taxable income (line 1 less line 3)	4			
5	Tax (19% of line 4)	5			
6	Carry-forward from 1994	6			
7	Interest on carry-forward (6 percent of line 6)	7			
8	Carry-forward into 1995 (line 6 plus line 7)	8			
9	Tax due (line 5 less line 8, if positive)	9			
10	Carry-forward to 1996 (line 8 less line 9, if positive)	10			

**Figure 6 - 3: Business Tax. Source: Hall & Rabushka, 1995:62**

Figure 6-3 (Form 2) above acknowledges corporate expenses and allows for a deduction of these business related expenses. Tax is levied at 19 percent of taxable income, the identical rate levied on individuals.

### 6.3.3.3 Advantages of Flat Consumption Taxes

The advantages of the Hall-Rabushka flat tax include its simplicity, economic efficiency and fairness (Gale, 1999:156). This method of taxation taxes income only once, in a uniform manner with no rate differentials depending on the type of income. The flat rate tax is pro-investment and non-discriminatory. The economic effect of these reforms would include improved incentives to work as the tax system (Gale, 1999:158) would not be considered hostile, while the increased capital formation due to the non-taxation of investment income will ultimately result in greater economic output and an increased standard of living. Removing the distortions created by inequitable tax rates would result in an increase in disposable income resulting in an increase in consumption across all sectors ultimately increasing demand for goods and services (Seldon & Boyd, 1996:8).

An important indicator of a successful tax is its ability to broaden the tax base and eliminate or reduce any tax avoidance opportunities (The Davis Tax Committee, 2016).

### 6.3.3.4 Tax Avoidance

Tax avoidance principles highlight three basic avoidance techniques: postponing taxes from current to future periods; using source-based arbitrage techniques to take advantage of the

taxation of different types of income and benefitting from rate based arbitrage (Calegari, 1998:692; Stiglitz, 1985:325).

Businesses who defer cash receipts across different years may be able to benefit from postponing taxes although the Hall-Rabushka flat tax lends itself to source-based arbitrage strategies due to the elimination of certain types of income from the tax equation (Calegari, 1998:692). Source based arbitrage is defined by Calegari (1998:689) as “arbitraging across different income streams facing different tax treatment”. Source based arbitrage could encourage a reduction in actual taxable income resulting in a lower tax payable. The Hall-Rabushka flat tax could in certain circumstances encourage this type of tax avoidance especially where income is diverted to a more favourable source thereby eliminating tax on income that has been earned and should be taxed at the flat rate of tax. Rate based arbitrage, defined by Calegari (1998:689) as “shifting income from high tax brackets to low tax brackets” is dependent on the tax system employed by the specific country and would be prevalent if the business and individual tax rates differ drastically.

Calegari (1998:710) concluded that tax avoidance will not disappear with the introduction of a flat tax; it will however reduce the incidence of tax avoidance. Developing countries with high tax avoidance and evasion problems could benefit from flat rate tax systems.

Another important issue when considering a flat tax is the basis of the tax: the age old consumption versus income debate.

#### **6.4 Consumption Tax Versus Income Tax**

Flat rate consumption taxes were initially advocated by Andrews (1974:1165) where he stated:

primary, intended, real effect of any general revenue raising tax is to curtail some part of the private consumption of economic resources that would otherwise occur, in order to free those resources for public use, including redistribution to the poor.

The consumption tax discussion continued with Warren (1975:932) debating this concept of taxing consumption versus levying taxes on the basis of accretion highlighting issues of economic goals other than fairness. The main point of contention raised between consumption and income being the exclusion of any amounts of income not consumed when consumption based taxation is employed. Warren (1975:934) acceded that taxing on the accretion or income basis (discussed in Section 4.3.3) creates a heavier burden when consumption is delayed reducing the after-tax investment amount. Andrews (1975:947), in his response, highlighted the

advantages generated by the elimination of any discrimination an accretion type tax produces from an efficiency and equity perspective.

The tax base, be it consumption or accretion, should consider efficiency and equity viewpoints to ensure an unbiased, non-discriminatory outcome. Flat taxes could be income based should this prove satisfactory for the jurisdiction concerned.

#### **6.4.1 Adoption of the Flat Rate Consumption Tax**

Although the modern flat rate tax was introduced in 1994 by the Baltic countries, the initial implementation of the flat rate tax was effected in Jersey since 1940 and Guernsey since 1960, with Hong Kong administering a dual tax system since 1947 (Heath, 2006:14). Jamaica introduced a version of the flat rate income tax in 1986 with personal income being taxed at 33,3 percent and corporate income at the same rate (Hadler *et al.*, 2007:16). Personal income tax rate reduced to 25 percent but the corporate income tax rate remained at 33,3 percent (Hadler *et al.*, 2007:17). The current wave of implementation of a variation of the Hall-Rabushka principle began in 1994. While all jurisdictions impose a single proportional tax rate their tax bases differ with taxes being levied on either consumption or income (Adhikari & Alm, 2016:4). However, to date no country has adopted the comprehensive version of the flat tax as advocated by Hall and Rabushka (Heath, 2006:14). Various digressions of the original Hall-Rabushka flat rate tax have been experimented with, though Croatia is the only country that opted for a flat rate consumption type tax.

#### **6.4.2 Croatia**

Croatia was the first country to implement the modern flat consumption tax in 1994. The Hall-Rabushka model of the flat rate tax was implemented at the personal income tax level only not at the corporate level (Blazic, 2009:6). Capital income or interest was not taxed and tax relief was in the form of tax allowances for dependent family members, disability or age with pensioners being entitled to almost double the basic allowance (Blazic, 2009:6). A non-standard social security contribution was also allowed as a deduction making this a mixed system consumption based tax (Blazic, 2009:4; Croitoru, 2017:30). It also sought to include income from real estate lending itself in the direction of a Schans-Haig-Simons (refers to all income earned including investment income) type of comprehensive taxation (Blazic, 2009:6). In 2001 with the introduction of dividend taxation and other rates and reliefs the consumption tax was discarded (Blazic, 2009:6). The 2001 comprehensive income tax was later abandoned in 2005 and Croatia reverted to the Hall-Rabushka type tax with some tax relief (Blazic, 2009:7)

Croatia presently taxes personal income at two rates 24 percent and 36 percent with interest on investments being taxed at a flat rate of 12 percent (Deloitte, 2018:3).

The predicament faced by a country like Croatia that implements one half of the flat rate tax i.e. only on businesses or personal income tax, is the possibility of taxpayers' enjoying the benefit of rate arbitrage among the other potential tax avoidance benefits that may inadvertently be present. This dilemma can be solved partially by levying a flat tax on investment income as has been recently implemented by Croatian authorities (Deloitte, 2018:3).

The Hall-Rabushka flat tax was not adopted in its true form although numerous countries have shown interest in this proposal. The expression "flat tax" has been used in a broader sense and adopted predominantly by the Baltic countries. Although critics of the flat tax continued to dismiss the adoption of the flat tax as a "temporary fad" most jurisdictions that adopted this reform have retained it (Blazic, 2009:1; Edwards & Mitchell, 2008:59–60). According to Mitchell (2008:4) no flat tax nation has returned to a progressive system of taxation even though Croatia attempted and now have a two rate personal income tax with a flat rate on investment income (Deloitte, 2018:3). However, Latvia reverted to a mildly progressive tax system in 2018. The flat tax succeeded in preserving the traditional requirements of an effective tax system, simplicity, efficiency and fairness while collecting the required funds needed by government (Greco, 2004:10).

The flat rate consumption tax was modified by numerous jurisdictions during policy discussions resulting in the implementation of a flat rate income rather than a consumption tax.

## **6.5 Flat Rate Income Tax**

When considering the adoption of a flat tax, two main issues are advanced: the tax rate structure and the choice of a tax base. Generally the Eastern European countries imposed different flat rates of tax on income rather than on consumption (Adhikari & Alm, 2016:5).

### **6.5.1 Types of Flat Rate Income Tax**

As different jurisdictions adopted modified versions of the flat income tax, the following broad categories were identified by Blazic (2009:2) (as demonstrated in the Table 6-1 below):

- Income-based tax with a single rate and no personal or basic allowance representing a true flat income tax in keeping with a proportional tax system – implemented only in Georgia

- Income-based tax with a single rate and a basic or personal allowance, which results in a progressive tax – the most common implementation with all other jurisdictions employing a version of this
- Income based tax with a single rate and a personal allowance which can exceed income when tax allowance/deduction exceeds taxable income, the resultant income is considered negative, not zero. This results in a progressive and negative income tax which is associated with Fredman’s model – 1962 – has not yet been implemented
- Income-based tax with a single rate and a non-wastable tax credit, a model advanced by Atkinson in 1995 which although progressive is in effect negative – has not yet been implemented.

**Table 6 - 1: Forms of flat tax**

<b>TAX BASIS</b>	<b>RATE OF TAX</b>	<b>ALLOWANCES</b>	<b>TAX SYSTEM</b>	<b>COUNTRIES USING IT</b>
Income	Single	None	Proportional	Georgia
Income	Single	Basic personal (wastable)	Progressive	All other flat tax jurisdictions
Negative Income (Can result in negative tax depending on income level)	Single	Basic personal tax deduction/allowance (non-wastable). When allowance /deduction exceeds income a negative state is reached NOT a zero level.	Progressive and Negative	Not implemented
Income	Single	Non-wastable tax credit	Progressive and Negative	Not implemented

(Source: Author's own adapted from Blazic, 2009:2)

Although a single income tax rate is present, the resultant tax can be proportional, progressive or negative as shown by the different models above. The proposals provide non-standard relief with a single tax rate which tends to simplify the tax system especially if corporate income is taxed at the same rate as individual income (Blazic, 2009:2).

Keen *et al.* (2006:5, 2008:714) described the present adoption of the flat tax as a “single strictly positive marginal tax rate on labour income”. The tax due is denoted by the following formula used by Keen *et al.* (2006:5) as a basis for their research relating to personal income tax:

$$Tf(Y) = \max [t \cdot (Y - Af), 0]$$

Where  $Tf(Y)$  denotes tax liability on labour income  $Y$   
 $t$  the single positive marginal tax rate  
 $Af$  some allowance depending on the country structure

The allowance in the above formula is dependent on the social security system in the relevant country (Keen *et al.*, 2008:714) depending on the taxpayers' circumstances (Keen *et al.*, 2006:5). Although certain flat tax countries introduced social security contributions which account for a part of the tax revenue, a deviation from the norm, their tax systems are still regarded as being flat (Greenberg, 2009:2). While tax on labour income may appear low, the overall effective rate of tax was altered depending on social contributions which led to the adoption of social contribution reforms when the flat tax was implemented in Russia and Georgia (Keen *et al.*, 2008:714).

Several countries introduced the flat tax as part of wider tax reforms which although not strictly the version proposed by Hall-Rabushka was considered an improvement to the progressive systems which they replaced (Greenberg, 2009:3; Keen *et al.*, 2008:714). In its pure form, a "flat (income) tax" would impose a single tax rate on the whole population irrespective of income levels thereby eliminating the redistributive role of taxes (Paulus *et al.*, 2009:2). Although this would simplify tax administration and provide a great deal of transparency, some detractors argue vertical equity issues would not be addressed. This probably prompted most jurisdictions to adopt a basic allowance for low income citizens, often supplemented by an allowance for families (Paulus *et al.*, 2009:2). Proponents of the flat rate income tax believe this basic allowance accommodates for vertical equity concerns. Flat tax reform is believed to have simplified the tax system which resulted in reduced tax administration and increased tax compliance (Paulus *et al.*, 2009:2).

### 6.5.2 Early Adoption of the Flat Rate Income Tax

The flat rate income tax is not a recent phenomenon with at least three countries having adopted this trend prior to the current 1990 implementation (Nicodeme, 2007:139)). Early adoptions of the flat rate income tax include Hong Kong executed through the Inland Revenue Ordinance of 1947 with its implementation being credited with the stunning rise of the island's economy (Grecu, 2004:12). Since its adoption, the inhabitants of Hong Kong had the choice between a graduated tax rate of between 2 percent and 20 percent on income adjusted for deductions and allowances or a flat rate tax of 16 percent on gross income (Grecu, 2004:13), a phenomenon referred to as a dual system of taxation. Although this dual taxation system allows taxpayers to minimise their personal tax burden, taxpayers predominantly chose the flat rate of

taxation as this offers lower tax rates, zero preparation costs and a vastly reduced probability of being audited by revenue authorities (Grecu, 2004:13).

The Channel Islands of Guernsey and Jersey which operate under special constitutional status bestowed by the Crown (United Kingdom) have become highly attractive to businesses due to their low tax rate, stable governments and lack of party politics since 1960 and 1940 respectively (Grecu, 2004:13). Both jurisdictions apply a flat tax rate of 20 percent to both individuals and corporate entities with generous allowances for both single and married individuals and allowances for children and dependent relatives (Grecu, 2004:13).

The three historic flat tax regimes were economically stable enjoying the status of tax havens where international investors chose to invest their surplus funds. This status was partially reversed when the traditional Eastern Bloc countries reverted to proportional tax systems.

## **6.6 Contemporary Flat Tax Regimes**

The traditional socialist governments of the Eastern Bloc countries followed the heavily graduated progressive tax system proposed by Karl Marx and Friedrich Engels in the Communist Manifesto in 1848 (Heath, 2006:14). This highly progressive tax system was pursued by Communist countries until the early 1990s when in 1994, the smallest of the communist Bloc countries, Estonia, revised their tax policy implementing the new generation flat tax (Heath, 2006:14; Mazure & Viksne, 2014:35).

### **6.6.1 Estonia**

The ex-Communist country, Estonia was the first modern adoption of the flat tax in 1994 at an initial rate of 26 percent which was perceived as “a great symbolic victory for freedom and democracy” (Heath, 2006:14; Sciaou & Moga, 2009:345).

A single flat rate income tax replaced a multi-tiered personal income tax system that comprised three rates of 16 percent, 24 percent and 33 percent (Hadler *et al.*, 2007:11). Although the International Monetary Fund warned against the implementation of this flat tax, Estonia energized its stagnant economy and the tax rate was subsequently reduced from the initial 26 percent to 20 percent in 2007 for both corporate entities and individuals (Smatrakalev, 2011:72).

Between 1994 and 2007, Estonia’s economic growth averaged 7 percent annually with government revenues rising sharply (Edwards & Mitchell, 2008:70). The flat rate tax encouraged capital formation as corporate taxes on reinvested funds were eliminated; this led to higher productivity levels, higher wages and job creation (Grecu, 2004:14). Estonia further enjoyed an influx of foreign investment due to its tax friendly environment (Grecu, 2004:14).

The main reasons cited for the implementation of the flat rate income tax were: the elimination of adjustments to the tax rates on an annual basis, ease of administration for both taxpayer and tax collector and transparency (Mazure & Viksne, 2014:35). Mitchell (2008:6) reviewed Estonia's economic achievement post flat rate tax implementation which achieved:

- economic growth averaging close to 9 percent over a six year period,
- a budget surplus over the same period,
- doubling of personal income tax revenues since 2000
- with corporate tax revenues rising by 300 percent during the same period and a subsequent reduction in unemployment rates from 12 percent to 6 percent.

Estonia and other Eastern Bloc countries were traditionally plagued by low tax revenue collection. These countries essentially needed to boost their economic growth while ensuring sufficient funds were collected to transform their countries into successful democratic states (Evans, 2006:52).

### **6.6.2 Latvia and Lithuania**

The implementation of the flat rate income tax in Estonia was followed by two other Baltic countries, Latvia and Lithuania, both of whom implemented the flat tax in 1995.

Latvia introduced a 25 percent flat rate income tax for both natural persons and corporate entities in 1995, but reduced the corporate tax rate to 15 percent in 2004 and further to 12,5 percent in July 2006 (Greco, 2004:14; Hadler *et al.*, 2007:12). The flat tax rate, until 31 December 2017 for individuals, was 23 percent with corporate entities being taxed at 12,5 percent. Following the implementation of the flat tax in Latvia tax revenues increased substantially due to robust economic growth and reduced tax evasion (Edwards & Mitchell, 2008:71). As of 1 January 2018, Latvia revised their personal income tax rates to:

- A rate of 20 percent applies to income up to EUR 20,004.
- Any portion of income between EUR 20,004 and EUR 62,800 attracts a rate of 23 percent.
- Any income over EUR 62,800 attracts a rate of 31.44 percent. (PWC, 2018:1)

Although personal income tax has become mildly progressive, the maximum marginal rate is well below the OECD standard of 38,1percent. Lithuania's radical economic reform policy in 1995 included the introduction of the flat rate personal income tax which was much higher rate

than its predecessors, a rate of 33 percent which was higher than the highest marginal rate prior to tax reform (Keen *et al.*, 2006:7). The personal income tax bracket replaced the previous multi-bracketed rate of between 10 to 35 percent. At implementation the corporate tax rate was reduced from 24 percent to 15 percent (Hadler *et al.*, 2007:12). Progressive reduction of this rate resulted in both individuals and corporate entities being taxed at a flat rate of 15 percent. Keen *et al.* (2006:7) noted a rise in the revenue collected from PIT post flat income tax implementation but an unexplained reduction in CIT revenue.

While prior to the implementation of the flat rate income tax all three countries (Estonia, Latvia and Lithuania) suffered inefficiency and economic stagnation, they experienced unprecedented economic growth post flat rate income tax implementation. This resulted in all three countries being referred to as the “Baltic tigers” at the turn of the century (Greenberg, 2009:2). However, Latvia reverted to a mildly progressive personal income tax system in 2018.

The flat tax helped create competitive economies and transformed ex-communist economies into free markets (Greco, 2004:15). While the Baltic countries introduced the concept of the modern flat rate income tax, the most influential experience was clearly Russia with its flat rate income tax implementation in 2001 (Ivanova *et al.*, 2005:400).

### **6.6.3 The Russian Flat Tax**

A brief history of Russia’s economic and tax setbacks will aid in the interpretation of the implementation of the revised income tax provisions.

During the 1990s, soon after the Soviet Union’s (USSR) move from a Communist state to a democratic Russia, economic policy decisions were determined by the Russian leadership and numerous economic agents who wielded considerable influence on policy decisions (Odling-Smee, 2004:38). The Russian government’s aim was to pursue liberal economic reforms to establish a market economy (Odling-Smee, 2004:54). The transition from a socialist state where the government owned everything to a liberal state where assets and economic resources are dispersed created challenges focussed particularly on the tax system (Preobragenskaya & McGee, 2004:5). However, opposition from within the government ranks ensured progressive economic reform was initially thwarted which led to the formation of oligarchs, a small group of businessmen who controlled the welfare of the State (Odling-Smee, 2004:55). These businessmen exerted their power to re-elect President Yeltsin in 1996 to ensure their influence on economic policies and their power over how much tax they would pay (Odling-Smee, 2004:56).

The economic crisis in Russia in the 1990s resulted in increased tax rates coupled with increased tax law enforcement but these measures yielded negative tax revenues and a reduction in GDP growth (Ready, 2011:12). The tax system of the 1990s was fraught with poor compliance, widespread use of tax incentives and inter-governmental upheavals (Ivanova *et al.*, 2005:404). It was reported that 90 percent of private tax income was concealed and subsequently unreported (Ivanova *et al.*, 2005:404). Preobragenskaya and McGee (2004:8) identified deliberate unclear tax laws which were open to interpretation and political factors that contributed to meagre tax revenue collections.

### **6.6.3.1 Tax Reform**

The minimal revenue collection fiasco was rectified when the three-bracket progressive Russian tax system at the rates of 12, 20 and 30 percent, was replaced with the 13 percent flat personal tax on 1 January 2001 followed by the 24 percent corporate flat rate on 1 January 2002 (Greco, 2004:15; Yew *et al.*, 2015:64). The aim of Russian tax reform was primarily to broaden the tax base and eliminate tax evasion opportunities. Although numerous measures were taken to broaden the tax base and the tax on personal interest fell from 15 percent to 13 percent, a special tax of 35 percent was necessary on “excessive” bank interest (Keen *et al.*, 2006:8). The Russian flat tax reform was correspondingly accompanied by major changes in the rate structure for social contributions (Keen *et al.*, 2006:8). In 2008 the corporate tax rate was reduced further from 24 to 20 percent (Trading Economics Russia).

Russia’s flat tax reform was quite revolutionary for a large country as the entire tax administration structure was reviewed along with the change in tax rate as part of a wider package of tax reforms (Gorodnichenko *et al.*, 2007:2; Keen *et al.*, 2006:5). The modernization of tax administration introduced a single tax identification number which allowed for indirect assessment of tax liability (Ivanova *et al.*, 2005:404). These reforms were implemented to potentially strengthen the effectiveness and powers of tax administration (Ivanova *et al.*, 2005:405). These tax administration modifications assisted in improving the tax base along with other developments.

The introduction of the Russian flat tax swayed the discussion relating to tax cuts and tax revenues. After the reduction of personal income tax rates, tax revenues increased substantially and almost immediately at a faster rate than labour supply and output (Gorodnichenko *et al.*, 2007:2; Papp & Takats, 2008:3). Although tax revenues increased by approximately 25 percent, about one-fifth relative to GDP, following the 2001 introduction of the flat tax, the increase was attributed to parametric (design features) reform rather than increased law enforcement (Paulus *et al.*, 2009:2). The increase in tax revenue can correspondingly be attributed to the

implementation of the flat tax that facilitated tax collection effectively reducing the level of tax evasion.

Other contributory factors towards the previous minimal revenue collection may be attributed to the adverse influence the division of the country into regional areas had (Libman & Feld, 2007:3). These regional centres resulted in unequal and unbalanced tax revenue distribution accredited to either composition of tax base or political privilege depending on the particular region (Libman & Feld, 2007:4). Although tax issues were centralized from 1994 certain regional areas, being heterogeneous in nature, unilaterally altered their tax rates within the federal range of tax rates (Odling-Smee, 2004:5). During the 1990s certain tax administration regions were seized while others introduced monetary substitutes or proxies who were used to protect local enterprises from federal taxation (Libman & Feld, 2007:7). These activities resulted in formal power-sharing deals which ultimately adversely affected tax revenue (Odling-Smee, 2004:5). Fortunately these regional structures were dissolved in 2000 resulting in seven federal districts where presidential representatives ensured the loss of power by regional governors (Libman & Feld, 2007:8).

These political and structural changes resulted in a consolidation of government policies, internationalisation of Russian businesses which required improved transparency and advancements in tax reform which reduced the level of tax evasion (Libman & Feld, 2007:8). Real collections from personal income taxes continued to grow by 21 percent in 2002 and 12 percent in 2003 before levelling out (Gorodnichenko *et al.*, 2007:2). This surge in tax revenue can be attributed to the implementation of the Tax Code 2001 (flat rate tax), improved performance of the real economy, improved voluntary compliance by taxpayers or more stringent enforcement of the tax system (Gorodnichenko *et al.*, 2007:2). Although compliance by higher income earners increased from 52 percent to 70 percent it remained unchanged for lower income earners who were unaffected by the rate change (Saavedra, 2007:261). Lower tax rates also encouraged behavioural responses such as change in the number of hours worked, number of jobs and income shifting (Yew *et al.*, 2015:65).

The economic effects of an improved tax system were noted in post flat rate tax Russia. The Laffer curve effect seemed to have been applicable in post-tax reform Russia with resultant enlarged tax bases and increased tax revenues (Krivka, 2006:74) when the tax rate was reduced. Various analyses have offered alternate explanations regarding the increase in tax revenue post reform. Krivka (2006:74) further noted the reform of income tax altered the distribution of tax revenues between the federal and regional governments encouraging more effective administration of tax. A simplified tax system released resources for tax administration and improvement of collection (Krivka, 2006:74).

Increased tax revenue, reduced tax administration costs with a simplified tax system should bode well for the economy of a country.

### **6.6.3.2 Economic outcomes**

The Russian economy responded to these factors that encouraged growth. Politically the Russian economy witnessed a rise in real income by 250 percent with real wages more than tripling (Djankov, 2015:3). Unemployment levels and poverty more than halved during the period from 1999 to 2008 (Djankov, 2015:3). Although these factors could explain the substantial increase in tax revenue (Gaddy & Gale, 2005:988), it unfortunately also created unequal opportunity at the top of the economic ladder moved from one group of billionaires to a new group with close ties to the present government (Odling-Smee, 2004:5). Djankov (2015:3) referred to this as the shift from crony capitalism to state capitalism where the main productive assets are held by the State or close friends and associates of the State (Odling-Smee, 2004:5) who would “put their companies at the disposal of the state in exchange for government contracts, access to easy credit through state-owned banks, and the protection of their wealth”.

Despite these political setbacks Russian tax revenue more than doubled during the first five years since the 13 percent flat tax adoption (Rabushka, 2006:1). The flat tax became a stable feature of the Russian economy and it contributed to a culture of compliance, a decline in capital flight and increased fiscal revenue (Rabushka, 2006:1). The Russian economy boomed while tax evasion was drastically reduced coupled with an increase in tax revenues suggesting an illustration of the Laffer curve in action (Edwards & Mitchell, 2008:72). Many international commentators though believe the Russian instance confirms lower tax rates enhance economic growth (Heath, 2006:83).

This economic boom continued until 2014, when economic sanctions were imposed on Russia due to political upheaval resulting in limited economic enhancement. However, the Russian flat tax reform has been touted as an economic success that resulted in substantially increased tax revenue and improved business opportunities which may have resulted in the adoption of the flat tax system by numerous other countries (Gorodnichenko *et al.*, 2007:35).

### **6.6.4 Later Flat Income Tax Adoptions**

Although most flat rate income tax countries have aligned their personal income tax (PIT) and corporate income tax (CIT) rates, certain adoptions were markedly different. The aligning of these rates discourages any tax avoidance mechanisms that may be employed.

Serbia, Slovakia and Ukraine migrated towards a flat rate income tax in 2003 with Ukraine choosing the Russian version where the PIT and CIT are not aligned (Edwards & Mitchell, 2008:3; Saavedra, 2007:256). Estonia (the initial flat rate tax adoption), Serbia and Slovakia chose to align their PIT and CIT at the same level with Latvia, Lithuania and Georgia (2005) adopting unequal PIT and CIT rates (Saavedra, 2007:257). These differences may reflect the timing of the implementation but a comparison of pre-reform tax schedules highlight the intention of policy makers (Saavedra, 2007:257).

#### **6.6.4.1 Serbia**

A 14 percent flat personal income tax was introduced by Serbia in 2003 replacing progressive tax rates that ranged from 10 percent to 40 percent. Serbia's growth showed an initial decline from 4 to 3 percent but more than doubled to 7,5 percent in 2004 and 5 percent in 2005 (Hadler *et al.*, 2007:15).

#### **6.6.4.2 Ukraine**

Traditionally, Ukraine with its pre-reform progressive tax system that was adjusted for inflation annually on an ad hoc basis provided an unstable environment for taxpayers. In January 2004, Ukraine adopted a flat personal income tax of 13 percent replacing a five bracket marginal tax which ranged from 10 percent to 40 percent (Keen *et al.*, 2006:9; Norregaard & Khan, 2007:29). This implementation followed Russia's example and brought previously exempt interest income into the tax net (Keen *et al.*, 2006:9). Revenue from personal income tax reflected a decline before it increased. After years of declining output and diminishing revenue, the real growth rate averaged about 7 percent between 2004 and 2007 (Edwards & Mitchell, 2008:73).

#### **6.6.4.3 Slovakia**

In 2004, the Slovak Republic (Slovakia) implemented a major, innovative tax reform resulting in a 19 percent tax rate for personal income tax, corporate income tax and VAT (Keen *et al.*, 2006:9; Norregaard & Khan, 2007:29). This replaced the previous five-tier marginal tax system which ranged from 10 percent to 38 percent while tax reform was accompanied by several fixed allowances and refundable tax credits (Keen *et al.*, 2006:9). Sciaou and Moga (2009:346) commented on the system of taxation that was replaced with the flat tax as "a mechanism with 90 tax exceptions, 19 non taxed income sources, 66 exonerations and 27 products with different level of taxation". Slovakia currently taxes personal income at a rate of 19 percent up to a tax base of EUR 36 367.76 where after any excess is taxed at a rate of 25 percent (Deloitte, 2019:3).

Although the post reform tax revenues fell by about 0,7 points of GDP much less than the predicted value of 1,2 points of GDP, Slovakia experienced a positive turn in its economy with it being hailed by the World Bank as the fastest transforming economy of 2004, the year of introduction of the flat tax (Hosalova, 2005:1; Keen *et al.*, 2006:10). Slovakia's Finance Minister at the time maintained that the flat tax did not in any way encumber production but provided an important stimulus for investment and job creation (Edwards & Mitchell, 2008:6).

Economic growth, adjusted for inflation, has averaged 6,6 percent post enactment of the flat rate income tax although it has been accompanied by other economic reform implementation (Sciaou & Moga, 2009:346). The flat tax is believed to have promoted enhanced productive behaviour resulting in higher than expected personal income tax collections (Sciaou & Moga, 2009:346). The comprehensive tax reform has coincided with improved compliance, enhanced foreign direct investment and received widespread support in the country due to its simplicity and transparency (Hadler *et al.*, 2007:16).

#### **6.6.4.4 Georgia**

Georgia introduced a flat tax on personal income at the flat rate of 12 percent in 2005 (Keen *et al.*, 2006:10; Norregaard & Khan, 2007:29). This reform replaced a tax schedule with rates of 12, 15, 17 and 20 percent. The uniqueness in the Georgian tax reform lies in the exclusion of a basic allowance rendering tax on labour income not only flat but proportional (Keen *et al.*, 2006:10). A substantial revenue loss was expected but total revenue remained essentially unchanged due to the adjustments made to other taxes (Keen *et al.*, 2006:11). Georgia's economy has grown convincingly post flat rate tax reform implementation with tax collections rising significantly from 14,5 percent of GDP in 2003 to an estimated 19,8 percent of GDP in 2005 (Edwards & Mitchell, 2008:75; Hadler *et al.*, 2007).

#### **6.6.4.5 Romania**

Romania replaced their five level marginal tax schedule with a flat rate of 16 percent in 2005 (Keen *et al.*, 2006:11; Norregaard & Khan, 2007:9). The reform included the taxation of dividends, interest income and capital gains at a rate lower than the flat rate which was subsequently adjusted to the flat tax rate of 16 percent (Keen *et al.*, 2006:11). Total revenue fell by about one percentage point of GDP post tax reform (Keen *et al.*, 2006:11). However, tax revenue income has since risen while the level of unemployment has been reduced followed by a rapidly growing economy ultimately resulting in tax revenue collection growing faster than anticipated (Edwards & Mitchell, 2008:74).

However, the Romanian revenue collection authorities reported a greater increase in VAT collection (VAT rate of 19 percent to be decreased to 18 percent in 2019) rather than an increase from personal and corporate tax collections indicating a higher level of consumption and not investment and compliance (Sciaou & Moga, 2009:346).

#### **6.6.4.6 Other European Adoptions**

The flat rate income tax was adopted by numerous Central and Eastern European countries (Rabushka, 2007:1) following the success realised by the Russian adoption. Most jurisdictions advanced different reasons for implementation but the general concept of a flat rate income tax was commissioned.

2006 saw the adoption of the flat rate income tax by Kyrgystan and Uzbekistan (Rabushka, 2007:1). Macedonia, Iceland, Mongolia, Montenegro, Kazakstan and Albania adopted the flat tax in 2007 at various, differing rates (Norregaard & Khan, 2007:9). The Czech Republic and Bulgaria implemented the flat rate income tax regime in 2008 (Norregaard & Khan, 2007:29). Macedonia's tax reform continued into 2008 when both individual and corporate tax rates were slashed to 10 percent (Edwards & Mitchell, 2008:76).

The most notable 2007 adoption of the flat tax is Iceland, a Nordic advanced Western nation. Edwards and Mitchell (2008:76) commented on Iceland's scrapping of "soak the rich" progressive tax philosophy to adopt a simple flat rate tax which has proved remarkable. Most of the previous flat rate tax adoptions were previously Communist controlled countries which can be identified as developing countries due to their lack of free market structures. Iceland, on the other hand, cannot be described as a developing country but rather a developed country where success with this tax system was observed.

The jurisdictions comprising the 'flat tax club' in Europe believe their favourable tax system encouraged foreign capital resulting in an increase in jobs and income levels (Edwards & Mitchell, 2008:6). The flat tax reforms were further intended to simplify tax collection, encourage the legalization of the shadow economy and make the economy more competitive (Edwards & Mitchell, 2008:77). Mitchell (2008:2) further remarked:

Flat tax systems also are leading to more revenue in many cases, reaffirming the Laffer curve notion that reasonable tax rates and strong economic growth are the best way to generate monies for government.

The adoption of flat rate income tax systems predominantly in the European region can be considered a success resulting in increased tax revenues, economic growth and reduction of

their shadow economies (Saavedra, 2007:266). However, the developing countries on the African continent appear a little reluctant to adopt this tax reform policy.

## **6.7 Africa**

As with most developing nations, the countries that comprise the continent of Africa are diverse. With a mix of agricultural and mining nations, the African continent has endured many political upheavals (Armah, 2015:1) resulting in less than adequate tax bases with fellow countries competing for limited foreign direct investment. Tax competition has actively influenced tax policy in Africa since 2005 when Egypt reduced its top individual and corporate tax rates from 40 percent to 20 percent (Edwards & Mitchell, 2008:7). Foreign direct investments play a vital role especially in underdeveloped and developing nations (Ravi, 2016:73). The Governor of Namibia noted the negative impact high taxes have on investments both foreign and domestic resulting in modest economic growth (Edwards & Mitchell, 2008:7).

In addition, Edwards and Mitchell (2008:7) observed for a country to be competitive in a region with the view of attracting foreign investment, tax regimes will have to be revised in line with other countries in the zone. The success of the majority of tax reform countries could be attributed to the simplicity and certainty of the post-reform flat tax as well as its rate competitiveness (Saavedra, 2007:265). However, it must be noted that the implementation of a flat tax is not a cure for all economic problems. Flat tax reform needs to be managed carefully with good governance philosophies and proper regulatory doctrines enabling an effective tax system (Mitchell, 2008:4).

### **6.7.1 Sub-Saharan Africa**

The African continent is notorious for its political unrest and economic mismanagement. Although endowed with abundant natural resources, the African continent has been plagued by limited foreign investment and high inequality during its colonial leadership (Armah, 2015:1). Independent Africa inherited high poverty rates, massive unemployment and underdevelopment of infrastructure (Sebudubudu & Mooketsane, 2016:145). A few African countries have succeeded in facilitating political and economic development while others tend to hinder such development due to various factors (Sebudubudu & Mooketsane, 2016:147) including ineffective tax systems.

### **6.7.2 Tax Systems**

Sub Saharan African tax systems should primarily highlight the redistributive role of taxation due to the substantial levels of poverty and unemployment (Di John, 2006:2). Politically other

redistributive factors should be considered, which may result in some economic limitations of the tax system. Bird and Zolt (2005:1631) believe the redistributory roles associated with taxation could take on numerous elevations:

- to reduce income inequality;
- to be politically acceptable as fair;
- the tax burden may be allocated with reference to different versions of fairness;
- to raise maximum revenue with the sole purpose of funding government expenditure;
- pro-poor tax policies that actually seek to address the misfortunes of the underprivileged in the country.

Each regime needs to assess which redistributory elevation is worthiest of its needs. A survey of tax incidence conducted by the International Monetary Fund on the effectiveness of income redistribution revealed poor redistribution of income due to the reliance of consumption rather than income taxes, with corruption and poor governance limiting the extent of redistribution and for political reasons (Bird & Zolt, 2005a:1638).

Adequate tax revenue ultimately enables countries to perform their routine functions ensuring economic growth and the ultimate redistribution of income to the underprivileged (Di John, 2006:2). Mauritius and Botswana are two such Sub Saharan African states which present advanced political and economic development (Armah, 2015:2). The political and economic growth levels of these two African countries have exceeded expectations and they have been termed Africa's miracles (Armah, 2015:10). The flat tax regime implemented in Mauritius which is discussed in Section 6.7.3 being hailed a success while Botswana, although not a flat tax regime has proved successful probably due to its fairly low maximum marginal tax rates for individual taxpayers is further examined in Section 6.7.4.

### **6.7.3 Mauritian Tax Reform**

Mauritius, an Indian Ocean island situated off the south-east coast of Africa, was the first African country to approve a flat rate income tax which was implemented on 1 July 2009 changing the outlook for tax reform in the greater African region.

Mauritius has fared rather differently to other countries in the Sub-Saharan region. James Meade, in 1961, predicted a dismal future for this island nation due to its vulnerability to weather, price shocks and lack of employment outside the sugar industry (Sebudubudu &

Mooketsane, 2016:150; Zafar, 2011:91). In 1968, after independence the Mauritian economy was extremely fragile, dependent solely on the sugar industry and plagued by what seemed to be irrevocable ethnic differences (Sebudubudu & Mooketsane, 2016:150). However, Mauritius progressed to middle-class status amid this adversity achieving unparalleled success in Africa (Sebudubudu & Mooketsane, 2016:150).

### **6.7.3.1 Economic Growth**

Economically Mauritius fared rather differently following the loss of trade preference in sugar and textiles. Mauritius launched a wide-ranging reform process in 2005/2006 (David & Petri, 2013:3) which sought to concentrate on other economically productive activities. Mauritius, like most other African countries, was dependent primarily on one agricultural source of income but has transformed itself from a poor sugar economy into a country with one of the highest per capita incomes among African countries (Zafar, 2011:91).

During the 2005/2006 fiscal year the Mauritian Authorities introduced major tax reforms aimed at base broadening and increasing tax progressivity (David & Petri, 2013:18). In 2007, a flat rate income tax of 15 percent was introduced on both corporate and personal incomes which helped streamline the tax administration process (Zafar, 2011:97). The flat tax system of 15 percent is accompanied by zero taxation on capital gains and dividends for residents which are also valid for international companies making it an attractive investment destination (Joseph & Troester, 2013:53). Finance Minister Rama Sithanen clarified his tax reform decision by indicating that numerous tax breaks and exemptions led to the vast number of abuse and avoidance opportunities apparent in the previous tax system which ultimately led to inequity and inefficiency (Edwards & Mitchell, 2008:77).

### **6.7.3.2 Flat tax implementation**

Prior to the implementation of the flat tax, tax rates in Mauritius were levied at a marginal rate with an exemption threshold for individuals contingent upon the number of dependents the taxpayer had (Lam Hung, 2006:248). The highest marginal rate relating to both individual and corporates for the 2006 – 2007 year of assessment was 22,5 percent which was decreased to 20 percent for the 2007-2008 year and further to 17,5 percent for the 2008- 2009 year of assessment (Lam Hung, 2006:249). The single rate of 15 percent came into effect on 1 July 2009.

By 2008 tax revenue amounted to 19 percent of GDP assisting the fiscal system absorb shocks (Zafar, 2011:97). The monetary policy in association with fiscal policy helped economic growth and ensured competitiveness (Zafar, 2011:97). In 2010 consumption taxes, VAT and excise

duty, accounted for half the tax revenue while corporate tax amounted to 15 percent with income tax on individuals accounting for 8 percent of total tax revenue (David & Petri, 2013:18).

Apart from the favourable tax system that was implemented in 2009, Mauritius boasts effective and efficient institutions that have ensured free and fair elections, the rule of law, an independent and vibrant press and respect for the divergent cultures which resulted in long run economic success (Subramanian & Roy, 2001:38). Despite the difference in ruling parties over the past four decades since independence basic policies like property rights and social security systems were standardised and followed by all political parties (Joseph & Troester, 2013:18). This unified approach resulted in stable political institutions enabling the country to make collective choices which result in economic growth vital for development of any country (Joseph & Troester, 2013:18). This begs the question of maintenance of this economic miracle which was addressed by various economists. Svirydzienka and Petri (2014:36) believe further improvements to business are essential to attract foreign investments, domestic investment needs to be generated and Mauritius' image as a politically stable, open and well-functioning economy needs to be maintained.

Mauritius, due to its location, is considered a Sub-Saharan African country and any analysis of the region has to include other countries in the region.

#### **6.7.4 Botswana**

When Botswana gained independence in 1966 it was considered one of the most underdeveloped countries in the world in terms of per capita income (Armah, 2015:11). Both Mauritius and Botswana have evolved setting them aside from most African nations who continue to backslide in their socioeconomic and political indicators (Sebudubudu & Mooketsane, 2016:151). Botswana's rapid growth can be attributed to an open economy, a considerable degree of foreign capital and a stable currency (Armah, 2015:11). Much like the Mauritian economy favourable but not flat tax rates encourage foreign direct investment in Botswana. The corporate tax rate is fixed at 15 percent with individuals being taxed as per table 6-2 below with the first 36 000 Botswanan pula (R49 320 as at 27 October 2018) being exempt from tax. Although not strictly a flat rate of income tax, the highest marginal tax rate is 25 percent, a very favourable rate compared to the South African top marginal rate of 45 percent. Botswana's income tax rates are not amended on an annual basis with the income tax rates for the previous and current years being illustrated in Table 6-2 below.

**Table 6 - 2: Botswana tax rate - 2015/2016**

Personal income tax rates - Resident individual taxpayers

Taxable income (BWP*)		Tax on column 1 (BWP)	Tax on excess (percent)
Over	Not over		
0	36,000	0	0
36,000	72,000	0	5
72,000	108,000	1,800	12.5
108,000	144,000	6,300	18.75
144,000		13,050	25

(Source: Botswana Tax Guide 2015/2016. PKF)

NOTE: BWP 1 = ZAR 1, 37 as at 27 October 2018.

Table 6-2 illustrates the personal income tax rates for business and employment income for individuals for the 2015/2016 tax year which have remained constant and identical for the 2017/2018 tax years. Economic growth can be attributed to the constant, transparent and fixed nature of the tax system resulting in taxpayers being knowledgeable in matters relating to taxation. This steady, unwavering structure is consistent with Smith's (1991:498) second canon (as discussed in Section 3.5.1).

### **6.7.5 Tax Rates and Economic Growth in Sub Saharan Africa**

Several suggestions have been made regarding the relationship between tax rates and economic growth. Analysing both the Mauritian tax rate, which is flat and low, and the Botswana tax rate which although not flat is steady and stable, with the highest marginal rate at 25 percent, a positive relationship between lower tax rates and economic growth can be inferred. Although tax policy decisions affect economic growth these decisions are dependent on policy ideas (efficiency, equity and growth), economic and social interests (capital, labour and poverty levels), strategic political institutions and economic goals which interact in the formulation of fundamental tax policy decisions (Bird & Martinez - Vazquez, 2008:56–57).

High tax rates tend to reduce the amount of savings and investment resulting in reduced economic growth (Liebfritz *et al.*, 1997:7). The progressively mobile investment scenario where investors seek the highest return on their investments in global markets (Swank & Steinmo, 2002:645) can be identified as a consequence of high tax rates and low incentives to save in the resident country. A further limitation of tax policy decision making and its wide ranging effects, especially in developing countries, is the stark reality of high shadow economies which adversely affect tax policy decisions. High progressive personal income tax rates have been

shown to have a limited scope in developing countries falling short of the desired level of redistribution while negatively impacting equity influences (Bird & Zolt, 2005a:1657).

The Sub Saharan African region particularly South Africa faces the unenviable dilemma of being surrounded by tax friendly states. These tax friendly regimes may seem particularly attractive to local and foreign investors (Di John, 2006:2), a situation which it can ill afford. To promote economic growth, South Africa needs to, among other factors, encourage tax compliance, eliminate tax distortions and ensure tax rates are efficient, equitable and administratively simple.

## **6.8 Effects of Implementation**

The introduction of the flat tax in Baltic states was characterised by moderately high tax rates (closer to the maximum marginal tax rate prior to reform) whilst the second wave beginning with Russia was marked by tax rates lower than the previous maximum marginal rates (Keen *et al.*, 2008:715). Depending on the method of implementation of the flat tax, a general positive effect has been broadening of the tax base (Bird, 2008:8). The first wave countries differed structurally in the implementation of tax reform with Estonia, Latvia, the Slovak Republic and Romania introducing a flat, identical tax rate for both personal and corporate income tax (Keen *et al.*, 2008:717). Numerous differences exist between the actual tax system and rate implemented by each country with some commonalities. The outcomes of these tax reforms particularly the second wave reformists generally referred to as the “10-percent area”, recorded gains in base broadening, horizontal equity and simplicity (Blazic, 2009:5; Keen *et al.*, 2008:716). They did not, however, achieve the required levels of efficiency (Blazic, 2009:5).

### **6.8.1 Highlights and Shortcomings of Implementation**

The Russian model characterised initially by massive revenue increases has been recognised as one of the more successful implementations. This rise in revenue collection, however, has been attributed to increased compliance as a result of improved tax administration (Blazic, 2009:5; Gaddy & Gale, 2005:985). Although the flat tax models are simpler than their counterparts, most jurisdictions have adopted tax relief measures without abolishing taxation of capital income completely (Blazic, 2009:5).

The elimination of some tax relief associated with pre-reform tax systems in Russia has resulted in broadening of the tax base, improved horizontal equity, some efficiency gains and simplicity (Blazic, 2009:5). Tax compliance increased by 17 percent during the flat tax reform period (Ivanova *et al.*, 2005:433) compared to the low levels of compliance prior to implementation. Tax rate cuts have a dual effect on tax revenues either affecting the tax base or affecting compliance with the tax rules (Papp & Takats, 2008:13). Ivanova *et al.* (2005:434) inferred

reducing the tax burden on individuals may have had a positive effect on taxpayer compliance through the reduction of the shadow economy. Taxpayer compliance may be affected by the complexity of the tax system which when simplified encourages taxpayers to comply. Papp and Takats (2008:13) further highlighted the trade-off between improving tax enforcement through penalties or improved resources versus improving tax compliance through tax rate cuts. Gaddy and Gale (2005:986) believed the oversimplification of the Russian flat tax reform is distorted as other reforms were noted during this period.

Proponents of the flat tax argue the simplicity of tax laws lowers administrative costs and encourages taxpayers to comply (Sciaou & Moga, 2009:344) while detractors of the flat tax system contend this system redistributes the tax burden from the rich to the middle-class due to its lack of progressivity (Gaddy & Gale, 2005:985; Norregaard & Khan, 2007:28). Sciaou and Moga (2009:344) argued, although the lack of progressivity does not comply with vertical equity norms, it can be dealt with by tax allowances and exemptions for lower income classes complying with vertical equity principles. Flat tax reforms tend to improve horizontal equity but reduce vertical equity depending on the nature of the implementation and exemptions and allowances legislated. Lindsey (1986:2) noted the importance of taxpayer response to tax rates has far-reaching fiscal policy implications, a significant advantage for the proponents of the flat tax. The size of the tax base depends on the rate of tax with a given percentage increase not necessarily producing the identical percentage increase in revenue (Lindsey, 1986:2).

### **6.8.2 Economic Consequences**

Flat tax reforms have been noted to have positive effects on compliance and simplicity without drastic surges or collapses on the revenue side (Saavedra, 2007:271). Mitchell (2008:2) highlighted the positive features of a single flat rate income tax as a tax that eliminates any special preferences that other tax systems may provide, with no double taxation implications and taxation at source.

The impact on revenue collected has however, depended on the design features and goals of the reform for the particular country in question. Apparent successful tax reforms in one country may not necessarily produce the desired objective in another. When implementing a flat tax clear objectives need to be articulated depending on whether compliance issues need to be addressed, revenue collection or equity requirements need to be met (Gale & Samwick, 2014:2). Complementary reforms may be required to expand tax bases and curtail undue revenue losses during the reform process (Gale & Samwick, 2014:2; Saavedra, 2007:272).

Table 6-3 demonstrates the advantages and disadvantages of the implementation of the flat tax at a glance while Table 6-4 highlights the adoption of flat taxes from its inception to current implementation. Flat income taxes, not consumption taxes were implemented by all jurisdictions.

**Table 6 - 3: Flat tax: Advantages and Disadvantages**

<b>ADVANTAGES</b>	<b>DISADVANTAGES</b>
Simple, easy to understand and implement	Simplicity results in loss of flexibility
Simplifies compliance and enforcement	Transition costs may be expensive
Improves taxpayer compliance	Inherently regressive polarizing wealth in the hands of the wealthy
Reduces compliance costs and tax avoidance and evasion	Tax burden is borne by the middle class
Higher incentives encourage employment and growth	Unhealthy fiscal competition may result in migration of labour to tax favourable regimes
Reduces the disincentive to invest	Increased inequality
Broadens the tax base	Distributional effects may affect political support
Reduces the size of the informal economy	
Encourages global competition which stimulates economic growth	
Overcome equity-efficiency trade-off in the long run	
Increased local and foreign investment	
No double taxation	

(Source: Author)

**Table 6 - 4: Flat tax economies - all jurisdictions adopted flat income taxes**

<b>Country</b>	<b>Date Implemented</b>	<b>Flat tax (PIT- post reform)</b>	<b>Pre – Reform</b>
Jersey	1940	20 %	
Hong Kong	1948	15 % or 2 % – 17 % (Dual rate)	
Guernsey	1960	20 %	
Estonia	1994	26 % reduced to 22 % further reduced to 20 %	16 % – 33 %
Latvia	1995	25 % reduced to 23 % until 2017	25 % - 10 % regressive

Country	Date Implemented	Flat tax (PIT- post reform)	Pre – Reform
		Three tax rates from 1 January 2018	
Lithuania	1995	33 % reduced to 15 %	18 % – 33 %
Russia	2001	13 %	12 % – 30 %
Serbia	2003	10 %	10 % – 20 %
Slovakia	2004	19 % added an additional rate in 2013 of 25 % for amounts over EUR 36 367.76	10 % – 38 %
Ukraine	2004	2004 13 % increased to 15 % in 2007 currently 18 % and 20 %	10 % – 40 %
Iraq	2004	15 %	
Georgia	2005	20 %	12 % - 20 %
Romania	2005	16 %	18 % – 40 %
Seychelles	2006	15 %	
Macedonia	2007	10 %	15 % – 24 %
Montenegro	2007	15 % currently 11%	16 % – 24 %
Iceland	2007	35, 7 % currently 46, 2 % including municipal rates progressive national rates 24,1 % to 33 %	46,9 %
Albania	2008	10 % replaced with 2 rates 13 % and 23 % in 2014	5 % - 30%
Bulgaria	2008	10 %	24 % – 50 %
Czech Republic	2008	15 % currently 22 %	28 % – 43 %
Bosnia	2009	10 %	
Mauritius	2009	15 %	15 % – 30 %
Hungary	2011	16 % currently 15 %	17 % – 32 %
St Helena	2012	25 % currently two rates of of 26% and 31%	

(Various Sources)

## **6.9 Equity and Efficiency of a Flat Tax in The South African Context**

Prior to the nineteenth century, flat tax regimes were the norm in Western Europe. Karl Marx, the founder of Communism introduced the idea of heavily progressive tax systems which was adopted by most jurisdictions (Sciaou & Moga, 2009:345) (Section 3.6.4). Most modern income tax systems are afflicted by progressive tax rates that offer deductions and incentives to certain taxpayers while including all investment income earned into taxable income (Vionea & Mihaescu, 2009:20). This is true of the personal income tax system in South Africa. The degree of progressiveness depends on the tax legislation which may be either heavily or mildly progressive with the maximum marginal rate currently, in South Africa, being 45 percent.

However, the taxation of returns from investments has dominated recent literature being described as unfair, inefficient or inconsistent with paternalistic and altruistic concerns (Bankman & Griffith, 1992:386). Pure income tax can be described as a consumption tax with uniform capital taxation resulting in the sharing of investment income with the tax authorities (Hubbard, 1997:41). Bankman and Griffith (1992:394) suggest when traditional income tax rules are applied to investment income, the tax authority becomes a partner to the investment as all gains are then shared with the government.

The equity, efficiency and tax base will be reviewed, with particular reference to the countries where the flat rate income tax was implemented, although some considerations may have been discussed previously in Chapter Four, these relate particularly to the implantation issues of the reform. A review of the South African tax reform landscape follows.

### **6.9.1 Equity Considerations**

According to Mazure and Viksne (2014:34), income tax philosophies in certain Baltic States incorporate principles of equity which result in the imposition of income taxes based on the taxpayers' creditworthiness, a principle based on the solvency of the taxpayer and not used as a basis for taxation in many jurisdictions.

With the introduction of the flat income tax reform in certain countries, the principle of horizontal equity is satisfied i.e equals are taxed equally (Mazure & Viksne, 2014:34). Tax relief and allowances are designed to achieve social and economic targets unique to the country to achieve vertical equity and efficiency requirements. Although economic allowances help encourage business development it could result in either an equitable taxation system or help create derogations from the equity principle (Mazure & Viksne, 2014:35; Vionea & Mihaescu, 2009:20). Allowances and incentives also tend to complicate the tax system raising the cost of administration (Mazure & Viksne, 2014:35). Norregaard and Khan (2007:30) believe the equity

impact of the flat tax in practice is less adverse than it appears as all jurisdictions who have adopted the system have provided for increased personal allowances which alleviate the distributional effects of the statutory rate change as reiterated by Vionea and Mihaescu (2009:20).

Keen *et al.* (2008:722) believe both horizontal and vertical equity is achieved if a basic personal exemption is included making a flat tax progressive since the average tax rate increases with the level of income. Some economists have expressed concern relating to the lack of progressivity of the flat tax while others have argued that progressivity improved due to the inclusion of untaxed income in the tax net (Norregaard & Khan, 2007:28).

### **6.9.2 Efficiency Concerns**

Economic activities are affected by income taxes, resulting in efficiency fluctuations. Proponents of the flat tax believe progressive tax systems raise the barrier against working extra hours, reinvesting and saving (Greco, 2004:5).

Progressive tax systems encourage higher maximum marginal tax rates which may exceed the maximum allowable tax rate on the Laffer curve which would result in a decrease in revenue (Greco, 2004:5). This negative aspect of progressive tax systems result in loss of efficiency. Efficiency is improved when income taxes least affect economic behaviour (Gale & Samwick, 2014).

In theory, a flat rate tax should have minimal effect on economic behaviour making it more effective than progressive tax systems (Saavedra, 2007:255). Saavedra (2007:255) argued the effects of a flat tax rate would result in the minimization of tax arbitrage, which is the shifting of tax liability from higher-taxed category of income to lower-taxed category of income. If labour supply is highly elastic, low and less progressive tax structures may increase the participation of highly skilled workers (Saavedra, 2007:255). However, if there are no exemptions in place for lower income earners, proportional tax rates may have an adverse effect on vertical equity and efficiency. Political economic literature offers the idea of better target ability versus efficiency which justifies the shift from efficiency due to political pressures (Castanheira *et al.*, 2012:3).

Equity and efficiency principles have been discussed extensively in Chapter Four and briefly in section 6.9.1 in section 6.9.2 of this text. However, as flat tax principles are based on either an income or a consumption tax, a brief overview of its importance on equity and efficiency follows.

### **6.9.3 Toss-up between Consumption and Income Tax**

Traditionally income tax places a heavier tax burden on individuals who prefer to delay consumption until later in life while a consumption tax is neutral as investment income is not taxed (Bradford, 2005:19). A heavier tax burden is placed on individuals who invest their earnings when an income tax is in operation even though they may be in the identical tax bracket as an individual who spends all their income.

Income tax principles choose to tax income when earned and when invested resulting in the horizontal equity argument favouring a consumption tax rather than an income tax as a base (Bradford, 2005:19). When considering vertical equity the desired degree of progressivity can be obtained by utilising a minimally graduated rate schedule when implementing the consumption tax (Bradford, 2005:20). Vertical equity can also be accomplished by eliminating loopholes and exemptions which tend to favour higher income earners (Saavedra, 2007:255) when an income tax is effective.

The principles of equity should be analysed from a broader fiscal perspective taking into account public expenditure (Saavedra, 2007:255). With the consumption tax, the investor's return is rewarded in full whereas with an income tax, the investor is penalised by being taxed on the investment income (Bradford, 2005:20). Hall and Rabushka (1995) emphasised efficiency of a consumption type tax at a constant rate as one of the arguments in favour of it.

When considering equity and efficiency principles policy-makers need to establish their primary objectives with respect to the implementation of tax principles. The choice between an income or a consumption tax, its effects on equity and efficiency and consequently its influence on total revenue collected is vital.

Although developed countries favour progressive income tax systems, policy makers in developing countries are faced with the more daunting task of ensuring a boost in employment, enhanced educational opportunities and an improvement in labour performances while ensuring adherence to the basic principles of equity and efficiency (Gale & Samwick, 2014:2). The toss-up between income tax and consumption tax was initially debated between Andrews and Warren in the 1970s and analysed further by Hall and Rabushka of equal importance, was the debate pertaining to whether income should be taxed progressively or proportionally.

### **6.9.4 Progressive Versus Proportional Tax with Vertical Equity Considerations**

As progressive rates are considered to promote vertical equity, a proportional tax could be seen as counterproductive for a country with huge inequality such as South Africa. This is considered

with the next table showing the gini rates of the countries who implemented the flat rate tax system.

Table 6.5 compares the Gini coefficient, in most instances, before implementation of a flat rate tax system and the 2019 Gini indexes. Due to the lack of sufficient available statistics, some Gini coefficients are not displayed. The post revision inequality marker is not substantially different to the pre-tax reform markers, with certain jurisdictions improving their inequality index post tax reform while many have not displayed significant changes.

**Table 6 - 5: Comparison of the GINI coefficient pre- and post-tax reform (World Bank Statistics)**

Country Name	Date of first GINI evaluation after flat tax and corresponding GINI index		2019 GINI
	Date	GINI index	
Jersey	1940	N/A	0.290
Hong Kong	1948	N/A	0.331
Guernsey	1960	N/A	N/A
Estonia	1993	0.395	0.374
Lithuania	1993	0.336	0.259
Romania	1994	0.282	0.273
Latvia	1995	0.31	0.365
Russia	2001	0.369	0.420
Serbia	2003	0.328	0.387
Iraq	2006	0.286	0.309
Slovak Republic	2004	0.271	0.253
Ukraine	2004	0.270	0.256
Georgia	2005	0.403	0.295
Mauritius	2006	0.428	0.358
Bosnia	2007	0.33	0.351
Iceland	2007	0.295	0.377
Montenegro	2007	0.357	0.262
Albania	2008	0.300	0.358
Bulgaria	2008	0.336	0.319
Czech Republic	2008	0.263	0.275

Country Name	Date of first GINI evaluation after flat tax and corresponding GINI index		2019 GINI
	Date	GINI index	
Macedonia	2009	0.314	0.377
Hungary	2011	0.292	0.291
St Helena	2012	N/A	N/A
Seychelles	2013	0.468	N/A
<b>South Africa</b>	<b>1993</b>	<b>0.593</b>	<b>0.625</b>

South Africa, although still considered the most unequal country, would benefit from a flat rate tax as it would promote efficiency, compliance, be simple, transparent and would help diminish horizontal equity concerns. Georgia, Mauritius and Seychelles, with fairly high gini coefficients successfully implemented flat rate income tax systems having reported increased compliance and revenue collected. Although the gini coefficient of Russia increased post flat rate income tax implementation, compliance, efficiency and revenue have increased as noted in Section 6.6.3.2. The index is, however, still lower than the current South African gini index.

The impact of these factors will be discussed in Section 6.9.5.

### **6.9.5 The South African Tax Reform Landscape**

The small personal tax base contributed over one-third of the total revenue with the GDP-to-Tax ratio being 25,7 percent, an indicator which represents the amount of tax collected relative to the size of the economy (Stats SA, 2019:2). Although the GDP-to-Tax ratio is a well-publicised economic indicator, it does not provide any assurances relating to the good governance, efficiency or equitable distribution of tax revenue (Stats SA, 2019:4). The ratio of individual taxpayers compared to corporate entities, is much lower in developing countries than in developed countries (Bird & Zolt, 2005a:1658), emphasising the role of this small base which contributes the major portion of total revenue, questioning its equitability.

The history of tax reform, as noted here, directs governments towards current globally accepted practices (Dom & Miller, 2018:28) in this instance towards simple, equitable and transparent tax reforms that reduce progressivity of the tax rates. In South Africa, the tax reform challenges include the delivery of a personal income tax that will deliver sustained levels of revenue while broadening the tax base. These reform measures would require unceasing political support (Dom & Miller, 2018:28) to succeed. Although tax reform measures are suggested, there is no

perfect tax solution that would eliminate all obstacles faced by the South African economy as a whole.

Although alternatives to these tax reform procedures were forwarded, some Nordic countries favoured the dual income tax over other systems.

### **6.10 Dual Income Tax**

Sørensen (2005:3) addressed the issue of personal tax based on ability to pay (Adam Smith's first canon- Section 3.5) and recognised conventional tax theory either favours Schanz-Haig-Simons comprehensive income tax (Section 4.3.3) or Fisher-Kaldor-Meade expenditure tax. Expenditure tax does not levy tax on investment income whereas comprehensive income tax levies the identical marginal rate of tax on both labour and capital income (Genser, 2006:272; Sørensen, 2005:3).

Certain Nordic countries, however, levy a progressive tax rate on labour income while levying a flat tax on any income earned from capital investments (Diamond & Zodrow, 2006:2). Hamaekes (2003:48) maintained this dual income tax which taxes labour income at a different tax rate to capital income will be beneficial both from equity and efficiency aspects. He concluded labour income was protected from the effects of inflation resulting in capital income being a riskier option and further highlighted the potential double taxation of labour earned savings (Hamaekes, 2003:48). Kleinbard (2010:43) defined a dual income tax as having "two tax rate schedules" with capital income being "comprehensively defined and taxed at one relatively low proportional (flat) rate" while labour income is taxed under a different progressive schedule.

Diamond and Zodrow (2006:4) further examined the desirability of imposing and maintaining a complex capital income tax system to raise a relatively trivial amount of revenue. A moderate level of capital income tax that exudes simplicity could satisfy efficiency and equity principles too (Diamond & Zodrow, 2006:4; Genser, 2006:272). Liebfriz *et al.* (1997:11) concurred with the view that the tax burden should fall on labour income as this is less mobile than the international capital income market. Reducing effective tax rates on investments may result in an increase in domestic investment and a probable increase in foreign investment depending on returns and tax rates in neighbouring jurisdictions (Liebfritz *et al.*, 1997:11).

Particularly high tax rates, both corporate and personal, may encourage the domestic tax base to relocate taxable profits and capital investments to tax friendly jurisdictions (Liebfritz *et al.*, 1997:11). Although labour tax rates are more flexible due to their potential immobility, these tax rates should be favourable enough not to discourage hard work.

Sørensen (2005:7) contended arguments in favour of a dual income tax include: a low tax rate on capital income relieves the negative effects of inflation on capital investments; it levels the imposition of income on capital investments as various investments are difficult to tax on an annual basis; it reduces any inherent tax arbitrage effects in the income tax; it eliminates the discrimination against taxpayers who save instead of spending their income. Keuschnigg and Dietz (2005:3) believe a dual tax is a compromise that aids in limiting the taxation of capital income while fulfilling the requirements of both equity and efficiency principles. Capital income is more sensitive than labour income and should be taxed at a lower rate to achieve efficiency while equity principles are upheld when a flat tax is levied on capital income (Keuschnigg & Dietz, 2005:3). The dual income tax for individuals which taxes capital income at a lower, possibly flat rate eliminates the investment saving distortion while achieving equity and efficiency.

Shaviro (1989:1221) suggested a test for equity by examining the net effect of the income tax system on after-tax earnings/income. In essence this test would involve a comparison of taxpayers whose income would be equal had there been no tax levied on it (Genser, 2006:273; Shaviro, 1989:1221). This would affect all income earners irrespective of the source of the income. Poor economic growth and grossly diminished economic growth in developing countries including South Africa could be attributed to the taxing of labour and investment income identically. Keuschnigg and Dietz (2005:3) expressed concern regarding tax levied on personal capital income as this discriminates against savers resulting in an inequitable tax.

Table 6-6 summarises the advantages and disadvantages of a dual income tax system as discussed above.

**Table 6 - 6: Advantages and Disadvantages of a dual tax system**

Advantages	Disadvantages
Helps reduce horizontal equity discrimination due to the timing difference between earning and consumption	Levying of a dual income tax does not strictly comply with the comprehensive income rules (Haig-Simons definition)
Favourable tax rates for capital income provides inflation indexing – an adjustment that is built-in when labour income is taxed	The changeover may create administrative difficulties and further costs as the distinction between labour and capital income needs to be scrutinized
Provides ease of taxing all capital income at a constant rate	Could create a basis for tax avoidance where taxpayers seek to transform labour income into capital income due to the favourable rates offered to capital income.
Eliminates tax arbitrage between	Dual income tax may undermine vertical equity

individual taxpayers (wealth transfer to lower taxed family members)	principles due to the lack of progressivity when levying a flat, low rate capital tax.
Hinders financial capital mobility as citizens are comfortable making domestic capital investments	
Reduces saving disincentives thereby encouraging domestic investment	
Limits erosion of the tax base and could expand the tax base by simplification of PIT and CIT	
Tends to decrease the size of the informal economy by reducing barriers to formalization	
Eliminates any tax preferences contained in the PIT and CIT systems.	

(Authors' own version adapted from Bird & Zolt, 2011; Genser, 2006; Sorenson, 1993)

From an economic efficiency perspective, Kleinbard (2010:45) argued the dual income tax is superior while he further contended that equity principles would perhaps surpass the current policies with a reasonably implementable dual tax system. The implementation of a dual income tax system would require fairly accurate measurements and capturing of the capital tax base (Kleinbard, 2010:45) to expand the current capital tax base.

With the marginal tax rates on both capital and labour personal income imposed in South Africa being much higher than neighbouring jurisdictions the unintentional capital outflow from South Africa to tax friendly neighbouring states could be unintentionally encouraged. The taxing of capital income is also increasingly difficult to track due to fast and cheap electronic services that enable investments to be made globally with relative ease. A lower rate on capital income reduces the appeal of tax avoidance (Kleinbard, 2010:46) and simplifies tax reform methods without undue burden on the tax system.

## 6.11 Conclusion

Globalization has resulted in an integrated economy which allows for the migration of human capital across national borders, a feature that affects equity in the domestic country due to lost tax revenue. This potential movement has resulted in increased tax competition due to the expectation of investors who are allowed to relocate to countries where their returns are maximised while minimizing their tax burdens (Edwards & Mitchell, 2008:15). Tax reform processes directly affect economic growth resulted in the search for the critical balance between tax base and tax rate, a phenomenon that could be referred to as an economically reliable tax system (Gale & Samwick, 2014:2). Although drastic tax reform processes have been rife in

certain regions with some jurisdictions introducing proportional tax systems to replace their progressive tax systems, the implementation methods did not follow the same general rules throughout jurisdictions that adopted it. Several countries, Georgia, Kyrgyzstan, Mongolia and Mauritius, set their flat tax rate at their previous lowest marginal rate (Nicodeme, 2007:139) while Macedonia and Romania set their tax rate just below the lowest marginal rate of their progressive systems with Russia setting the rate just above the lowest marginal rate (Nicodeme, 2007:139). However, Latvia and Lithuania set their flat rate at the highest marginal level of their progressive tax system (Nicodeme, 2007:139) with Latvia reverting to a mildly progressive system in 2018. Although differing in their adoption of tax rates all countries have nonetheless reported economic growth with increased total tax revenues post flat tax execution irrespective of the nature of implementation highlighted in Sections 6.3; 6.5; 6.6 and 6.7.

The lessons that can be learned from the adoption of the flat tax in over thirty countries to date revolve around a combination of principled leadership, tax competition and learning by example (Adhikari & Alm, 2016:1). The flat tax pioneers and their economic advisors were clearly motivated by good tax policy and the implementation of pro-growth reforms (Mitchell, 2007:10). Lower tax rates reduce discriminatory burdens on savings and investments resulting in a healthier fiscal climate that attracts capital investment from other countries while reducing the movement risk of domestic taxpayers (Mitchell, 2007:11). To date, most countries that have adopted the flat rate tax have enjoyed increased economic growth, lower percentage of unemployment and vastly improved tax compliance (Mitchell, 2007:11).

However, implementation of the flat tax usually forms part of a broader tax reform which can assist in simplifying income tax, reducing tax planning, evasion and avoidance (Bird, 2008:9). The effects of the flat tax are less noticeable in developed countries as only a few states in the United States of America employ a flat federal tax with other developed countries still considering implementation, but has proved highly effective in less developed and transition countries. In the countries that adopted the flat tax, efficiency improved mainly due to its simplicity and transparency. Equity arguments were also fulfilled in most jurisdictions where the lowest income earners are not taxed fulfilling the requirements both of vertical and horizontal equity (Section 4.4).

The ideal tax reform mix would focus on structural amendments to the income tax legislation coupled with legislation relating to compliance issues (Dom & Miller, 2018:24) to ensure all functions of income tax are included.

Flat tax reforms appear to have had positive effects on compliance and administrative factors relating to tax (Gale, 1999:155). Most jurisdictions reported increased compliance post flat tax

adoption. There have been no major revenue surges or revenue collapses but it has been shown that revenue impacts largely depended upon the goals of the reform and the tax design selected by the particular jurisdiction (Saavedra, 2007:271). There is no perfect tax for the economy (Dom & Miller, 2018:24); however, the flat tax moves the system closer to the ideal goals of raising revenues demanded by the government in the least destructive and least intrusive manner (Mitchell, 2005:7). Proponents of the flat tax are convinced that:

flat tax can be expected to increase the supply of labour (especially of women and older men), facilitate entrepreneurship, risk-taking and the creation of small businesses, make investment more worthwhile, including spending on human capital (such as education and training), help attract foreign direct investment, overseas capital and migrants (especially skilled, high-productivity workers), and bring part of the grey economy into the official economy because tax rates are kept lower, thus reducing the incentive for avoidance or moving assets into foreign tax havens (Heath, 2006:12).

Keen *et al.* (2008:721) enhanced the argument for the flat tax with a political reason for linearity:

For those who see government not as benevolent but rather as inclined to waste and pursuit of the narrow self-interest of policy-makers themselves, adoption of a flat tax can be desirable as a means of restricting the size of government.

The flat tax system is not without its detractors who believe vertical equity measures are not sufficiently addressed with the implementation of the flat tax. The future economic success of any jurisdiction is not guaranteed (Dom & Miller, 2018:27); however Mauritius (Section 6.7.3) has proven that the right economic instruments can weather a range of economic shocks (Zafar, 2011:104). Its history of adaptability, innovation and anticipating global changes coupled with good governance and sound macroeconomic policies has resulted in Mauritius being a leader in the Sub-Saharan region. While the flat tax may not necessarily produce massive changes, other economic benefits may assist to ensure the success of revised fiscal policy decisions (Mitchell, 2008:4).

The introduction of a flat tax is not without its shortcomings with the South African context at present being particularly problematic due to the highly progressive tax rates imposed on individuals. High progressive personal income tax rates encourage tax arbitrage (Calegari, 1998) both domestically and internationally. Fair tax principles that encourage lower tax rates albeit progressive may be best suited to the present South African economy as this would ensure a broadening of the tax base and reduced scope for tax arbitrage with minimal outflow of capital similar to the tax system in Botswana. Dual income tax which levies a different rate of

tax on investment income as compared to labour income may be the initial solution to the problem. When analysing tax reform methods and rates it would be preferable to follow the advice of many esteemed economists who have deliberated extensively and in the words of Mill (1848:V.2.7)

As a government ought to make no distinction of persons or classes in the strength of their claims on it, whatever sacrifices it requires from them should be made to bear as nearly as possible with the same pressure upon all [...] Equality of taxation, there-fore, as a maxim of politics, means equality of sacrifice.

Unfortunately, Mill did not indicate whether the tax system should be progressive or proportional.

This chapter highlighted alternate tax systems focussing on flat tax reforms, their implementation and outcomes. A study of dual tax systems was executed with its advantages and disadvantages although a detailed study of its implementation was not examined. Equity challenges coupled with efficiency, simplicity and fairness consequences relating to these alternate tax systems consistent with the primary and secondary objectives of this research have been reviewed.

With global attention on equitable and efficient tax reform systems the final chapter serves to collate the information gathered in the previous five chapters while interpreting the findings.

## **CHAPTER SEVEN: CONCLUSION AND RECOMMENDATIONS**

### **7.1 Introduction**

Although the primary function of a tax system is to raise revenue for infrastructure and redistributive purposes (Avi-Ronah, 2006:3), its implementation may be employed to achieve various political and policy objectives (Brodzka, 2013:28). The general traditional perception of imposing a fair burden across taxpayers (Avi-Ronah, 2006:1) is highlighted as the leading focus of this study with an investigation into popular tax reform strategies that have revealed advanced fiscal aspects such as enhanced transparency, reduced levels of tax evasion and the improvement of the State's position in relation to its neighbouring countries.

As a developing democratic country, the impact of taxes in South Africa has far-reaching consequences which may prove controversial to some (Section 5.8). Income redistribution is achieved primarily through the mechanisms of taxation, the redressing of which has occupied the minds of economists for centuries due to the major discrepancies that exist particularly in developing countries (Bird, 2008:3). Other than the revenue collection and redistributive functions, the regulatory purpose which helps steer private sector activities in a certain direction (Avi-Ronah, 2006:3) is of importance. Although taxes may appear enormous and coercive (Di John, 2006:1) they perform a significant function while influencing major economic decisions.

This begs the question relating to the importance of this study in a country that is experiencing low economic growth, with a rather minute tax base and a significant shadow economy. Heady (2001:12) and Bird (2008:4) argued the most effective tax reform systems broaden the tax base while attempting to lower tax rates designed to minimize revenue loss and foster economic growth (Dom & Miller, 2018).

To achieve this end of base broadening, revenue maximizing and favourable economic growth, a study of equity principles, their importance in any tax system and historical significance was undertaken. During this journey, a number of related factors, economic and non-economic, were exposed that impact either negatively or positively on the primary goals of an effective tax system. Economic equity, together with its associates was analysed in Chapters Three and Four, a study of the current income tax legislation as it pertains to personal income tax in South Africa was analysed in Chapter Five with contemporary tax reform measures being highlighted in Chapter Six.

Although this study evaluated equity and its importance to the primary functions of taxation, it is limited in scope to the investigation of personal income tax systems only. Corporate income tax, value-added tax and other taxes were not considered.

Chapter Two dealt with the research methods and methodology employed to achieve the objectives of this research.

## **7.2 Review of research problem**

The current South African Income tax legislation levies a progressive tax on personal income including any passive income earned on capital investments with minimal incentive allowances. A review of the Tax Statistics (Section 5.5.2) highlighted the increased burden being placed on individual taxpayers with Tanzi (2004b:534) referring to personal income tax as the “workhorse” of the South African Tax System.

Tanzi and Zee (2000) substantiated by Bird and Zolt (2011) recommended personal income tax collections in a developing country be lower than that of corporate revenue collections. According to the official tax statistics published by National Treasury and South Africa Revenue Services corporate revenue collection is at least half that of revenue collected from personal income tax, a feature distinctive of a developed country.

This problem was further highlighted by Maroun *et al.* (2011:436) in Section 5.2 where it was declared that

- any double taxation i.e. taxation on income and capital erodes the taxpayers’ ability to generate further income,
- the adverse effects of the implementation of residence based taxation,
- the application of the ability-to-pay concept rather than the ability to bear the tax burden and
- the unattractiveness of a progressive tax system which may result in undue burden being placed on the taxpayer (Vivian, 2006:84–85).

These complications relating to personal income tax adversely impact total revenue collected resulting in unjust consequences when equity, efficiency and fairness are considered during tax reform processes.

This study aimed to address:

Equity within the present personal income tax system in South Africa, expand on issues that impact equity directly with the prospect of improving the present progressive system with a non-progressive system while evaluating current tax reform approaches in transition and developing countries in search of possible solutions.

The primary objective was to assess the equity issues inherent in the taxation of natural persons in South Africa and the consequences related to the implementation of alternate tax reform systems.

which were enhanced by the study of:

- A historical review of the economic principles and history of taxation as suggested by economists past and present (Chapter 3)
- Expansion of the economic principles focussing on equity and fairness with its resultant effects on the shadow economy and taxpayer perception. A study of efficiency is also included as modern economists believe there is a trade-off between equity and efficiency (Chapter 4)
- An analysis of the Income Tax Act 58 of 1962 with historic and current tax commission findings relating to the incentives and deductions for individual taxpayers to address the advantages /disadvantages of the present tax system in South Africa and its resultant effect on equity, efficiency, fairness and the total revenue collected (Chapter 5)
- An investigation into alternative tax reform systems, their implementation and impact on equity and fairness in the countries that have implemented these globally (Chapter 6)

Coupled with the investigation and review of the current income tax situation relating to natural persons in South Africa and to format a suggested solution to the problem the following was determined in the study – (chapters 3 to 6)

### **7.3 Economic History of Taxation**

To understand the concept of equity, a historical study of the merits of this principle was initially undertaken in Chapter Three to establish the significance of this concept. The equity journey began well before contemporary concepts and principles were established and proved rather interesting.

Economic policies were encountered as early as 500 BC although related information is scarce and not adequately documented. The first authenticated script is the *Arthashastra*, a concise work compiled by an Indian economist, Kautilya, in about 300 BC that highlighted the concepts of fairness, efficiency, compliance, stability and the importance of capital formation in Section 3.3.2 (Tanwar, 2014:34). Kautilya, a contemporary of Aristotle, emphasised the significance of a tax system that would provide adequate revenue for public services without stifling economic growth (Waldauer *et al.*, 1996:101). He advanced the notion of an ideal tax system being fair, just and following the principles of maximisation of tax revenue while promoting economic growth and development by efficient utilisation of resources (Waldauer *et al.*, 1996:104).

Section 3.3.1 provides an overview of the earliest known civilizations and their taxation systems although information relating to these is sparse. The ancient methods of taxation included the *curve*, a form of statute labour (Forbes, 1965:5–6) and the *tithe* which represented the collection of a certain percentage of the landowners' crops (Burg, 2004:viii). A fixed percentage of the crops were 'donated' (Salanie, 2003:2) which in Egypt and Palestine amounted to twenty percent of the produce, with twenty-five percent being demanded in ancient India (Pei, 1972:182). The fixed percentage imposed on crops could be interpreted as a proportional tax system albeit rural.

Further exploration advanced the tax systems to the "taille", a system of ordinary and extraordinary taxes with exemptions being extended to the King and religious organisations (Pei, 1972:186) (Section 3.3.3) and the *tithe*, a proportional tax, with numerous Kings taxing various aspects of everyday life.

The *tithe*, among other taxes, is referred to in the *The Holy Bible* (1971) and is characterised by the payment of one-tenth of income to the respective organisation, in Biblical times to the church (Section 3.2.1.1) (Miller, 2012:4–5; Oden, 1984:165–171). Although various taxes were levied during the Biblical era (Section 3.2.1.1), some proved more demanding than others. However, Oden (1984:174) documented an interpretation of equity in this primitive tax system.

This search then explored other theological scripts to ascertain their respective views on tax (Section 3.2.1.2, 3.3.1.3 and 3.2.1.4). The tax principles of Judaism is controlled by various decrees the most important of which dictates a *tithe* (Chodorow, 2006:280), a proportion of one's income paid as taxes, much like *The Holy Bible* (1971) (Section 3.2.1.1). In contrast to *The Holy Bible* (1971), the *Torah* imposed three tithes for three different reasons based on a 7-year Jewish calendar cycle (Chodorow, 2006:277). The *tithe*, as imposed by religious texts, could be interpreted as a proportional tax of 10 percent.

Alternatively, the *Holy Koran* advocates a tax referred to as zakat or a wealth tax which is obligatory at a rate of 2,5 percent of nisab which is the point where wealth exceeds a certain basic level (section 3.2.1.3) (Mossavar-Rahmani & Maleki, 2009:32). Zakat is considered compulsory although other forms of taxation existed in ancient times (Dangkua, 2015:1). The levying of zakat, a fixed rate wealth tax, can be interpreted as being consistent with the principles of proportional taxation.

Hindu religious scriptures were, however, not as explicit (in Section 3.2.2.4) but followed the teachings of Kautilya's *Arthashastra* and the *Manusmriti*, a text that advocated the payment of 1/5<sup>th</sup>, or 20 percent, of the profits of traders and artisans in silver and gold, while the agriculturists were to pay 1/6<sup>th</sup> (16,67 percent), 1/8<sup>th</sup> (12,5 percent) and 1/10<sup>th</sup> (10 percent) of their produce depending upon their circumstances (Sinha, 2005:288). These teachings comply with proportional rather than progressive taxation principles.

The preceding discussion and that contained in Section 3.2.1 indicates the major religious texts and ancient teachings promoted proportional rather than progressive tax principles.

### **7.3.1 Early Economic Writings**

Section 3.3.4 recognises the contribution made by medieval scholars between the period 800 AD to 1 200 AD who acknowledged the principles of equity and fairness and the need for taxes to be collected with leniency and justice without exceeding the ability-to-pay norms (Chapra, 2008:16). The economist, Khaldun, (Gazanfar, 2000:857) substantiated the economic principles of efficiency, equity, neutrality, ability-to-pay and convenience (Section 3.3.4.2) (Ahmad, 2015:15; Chapra, 1999:27). These principles were later noted in the works of other economists with Laffer acknowledging Khaldun as the founder of the Laffer Curve principle.

Western economic thought was established in Chapters 12 and 14 of the Magna Carta (1215) (Section 3.3.3) which stressed the importance of a reasonable and equitable tax system and contained elements of sacrifice, benefit and redistribution of income (OLL, 2015:23). The Magna Carta, although a loosely drawn document sought to remove taxing power from the feudal lords but was later revoked. Later economic outcomes were fairly well-defined and proved more satisfactory than earlier findings.

### **7.3.2 Later Economic Findings**

Schumpeter (1986:197), as noted in Section 3.4, said that the seventeenth century and early eighteenth century economists were not structured in their thought processes regarding taxation which yielded an irrational and unsystematic system. However, Vauban and Boisguillebert

(Section 3.4.3) proposed a single proportional tax on all income or property (Rothbard, 2006a:371). Vauban further suggested a ten percent general income tax (Schumpeter, 1986:197) (Section 3.4.3) with these outcomes being echoed in many ways by Quesnay who believed taxes should be low and proportional but confined to tax on land (Musgrave, 1985:22; Rothbard, 2006a:372) (Section 3.4.4) which can be interpreted as tax on capital rather than on income.

Classical economists, the era represented from 1776, subsequently featured prominently with Smith being the most popular. Smith (Section 3.5.1), a British economist, divided taxation principles into what became known as the four canons/maxims of taxation (Section 3.5.1.2), denoting equity, certainty, convenience and efficiency, a system still employed to date (Smith, 1991:498–499). These canons are believed to form the basis of any tax policy and should be adhered to.

Later classical economic writings include (Section 3.6) economists who either supported or deviated from the Smith principles (Rothbard, 2006b:19). Say (Section 3.5.2.3) admitted taxes are harmful but promoted the merits of a progressive tax system (Say, 1971:454) but concluded “the best tax is always the lightest” (Rothbard, 1994:89) contrary to the principles of a progressive tax system. The very controversial Say (1971:447–449) believed taxation was an invasion of personal rights and believed the least cumbersome tax would be moderate without being extreme.

The second half of the eighteenth century witnessed the birth of socialism with Marx being the first economist to actively endorse progressive tax systems, in Section 3.6.4, with his socialist ideals. Marx advocated for a heavy or graduated tax system in the Manifesto of the Communist Party (Marx & Engels, 2010:26).

Later economic contributions (Section 3.6) debated the merits and failures of earlier economists and proposed what would later become known as the optimal tax theory concept. DuPuit along with Rau, von Mangoldt and Jenkin formulated the modern day concepts of total utility, consumer surplus, deadweight loss and the Laffer curve relationship (Hines, 2007:4; Humphrey, 1992:6). Although Wicksell (Section 3.6.2) supported mixed economies where governments played a major role he endorsed the progressive tax system forwarded by Karl Marx. The birth of the concept of efficiency (DuPuit in Section 3.6) can be attributed to this era as can the theory of optimal taxation (Ramsey in Section 3.6.3).

Twentieth century economists (Section 3.7) advanced the notions of capitalism and socialism while debating the ‘best fit’ tax to facilitate the redistribution of income in an optimal tax

situation. Hayek (Section 3.7.1) emphasised the importance of stability and continuity in tax policy while promoting the principles of a proportional tax system. He believed progressive tax systems create unwanted obligations between the worker and the growth of the economy (Estrada, 2010:5).

The most notable and relevant contemporary economists for this study are Hall and Rabushka who resurrected the modern day theory of the flat tax (Section 3.7.9 and Section 6.3.3). They developed a tax system that would require a simple tax return with a tax based on consumption rather than on income. These economists believed this adoption would “create an “airtight” system for including income in the tax base once and only once, as close to the source as possible” (Hall & Rabushka, 1995:38–41). Hall and Rabushka trusted this proposal would achieve simplicity, economic efficiency and fairness while collecting adequate amounts of revenue to finance public spending (Greco, 2004:10).

The historical perspective of taxation as reviewed in Chapter Three, established the importance of the principle of equity and related economic findings which were reviewed in the Chapter Four.

#### **7.4 Equity and its related theories**

Tax revenue collection is of vital importance in any capitalistic market with the design and implementation of a tax system in developing economies (Bird, 2008:1) highlighting the magnitude of salient economic features of equity and efficiency among others. Most economists refer to the concepts of fairness and equity interchangeably, with Duff (2008:3; Fleming Jr *et al.*, 2001:306; Martinez, 2004:416) defining both concepts as separate entities which this study chose to follow.

The benefit and ability-to-pay principles, noted in earlier historical writings (Section 3.5.1) form the basic components of an equitable tax system (Galle, 2008:1329; Genser, 2006:272). Although various economists debated these theories, they ultimately concluded both concepts were important to reach a state of optimal taxation (Weinzierl, 2014:18), a thought forwarded by Ramsey (Section 3.6.3). Duclos *et al.* (2003:1) believed the two fundamental economic principles of equity and efficiency were vital to any tax system. Other associated factors include globalisation which Musgrave and Wilson (1992:364) alleged affected equity and efficiency between jurisdictions.

### **7.4.1 Efficiency**

Efficiency concepts were first observed during the Classical era and concentrated on “reducing to a minimum the tax system’s interference with economic decision making” (Infanti, 2008a:1201). Efficient taxes (Section 4.3) should produce legislative outcomes that minimize the impairment of economic value (Buchanan, 1993:404). King (1980:1) argued that any tax structure could embody incentive and disincentive properties which could result in either efficiency gains or losses.

An insight into taxation theory associates efficiency with administrative competence and the proficient allocation of resources which leads to the discussion on incentive allowances and their role in an efficient tax system (Bittker, 1979:736). Sørensen (1993:19) further admitted that progressive tax rates result in inefficiency due to the difference in after-tax income resulting from the taxation of capital income. However, an important factor noted during this study was the significance of deadweight loss (Section 4.3.2), first discovered by DuPuit and others (Section 3.7) a concept otherwise referred to as the excess burden of taxation and its impact on future tax policy. The ultimate objective of any tax system would be to reduce the deadweight loss to a minimum which would increase revenue collection and efficiency of the tax policy. Elkins (2006:47) concluded a reduction in deadweight losses can be achieved by moderating the substitution effect requiring the imposition of an identical tax burden on every course of action available to a taxpayer.

The consequences of employing an income versus a consumption tax were further debated in Section 4.3.3. Most jurisdictions, including South Africa, employ a version of the Haig-Simons definition of income which includes consumption and the net change in wealth per annum (Armour *et al.*, 2013:2; Barreix & Roca, 2007:127). Although alternate definitions of income were offered by Hicks in 1939 with Haig later suggesting a consumption based definition, the accretion based income definition is the most widely accepted. The downfall of this accretion based method, as noted by Saxton (1999:4), is the resultant taxation of investments more than once. The definition of income is important as it further determines total revenue collected and the administrative efficiency of the tax system (Bird, 2004a:135) while impacting on equity.

### **7.4.2 Equity**

Various authors described the term equity in Section 4.4 with there being little consensus whether fairness is an integral component of equity or a principle on its own. This study separated the components of equity, horizontal (section 4.4.1) and vertical (section 4.4.2) and the controversial issue of fairness (section 4.5). Horizontal equity requires that equals be treated

equally, whereas vertical equity requires an “appropriate pattern of differentiation among unequals” (Repetti & McDaniel, 1993:607), while Varian (1973:2) stated that a minimal requirement for an allocation to be fair is if it is both equitable and Pareto efficient (Section 4.5) with Pareto efficiency being defined as a state where any reallocation of resources would not be beneficial to any individual without making at least one individual worse off (Pressman, 2014:110).

Horizontal equity principles advocate the taxing of equally well-off individuals equivalently irrespective of their earning capacity (Elkins, 2006:47). This concept addresses the principle of equal sacrifice as its basic theory which can be traced back to Mill (Galle, 2008:1329). Balcer and Sadka (1986:81) further noted equal treatment would result in equality both pre-tax and post-tax where equality (section 4.4.1.2) can be identified as a state that enables the identical result when different value items are measured and compared. In 2004, Lambert (2004:39) upheld the view that horizontal equity should offer “protection against arbitrary discrimination” while Galbiati and Vertova (2008:389) offered the alternative of “normatively appropriate equals” being taxed equally.

Vertical equity as discussed in Section 4.4.2 “serves to assess the equity of that impact on individuals with differing initial levels of well-being” (Duclos, 2006:2). Vertical equity further relates to societal distributive or allocative justice (Galle, 2008:1324) with certain economists believing it is only present in progressive tax systems. To this end, vertical equity is measured by the progressivity of the tax with emphasis on the value of the Gini coefficient (section 4.4.4) which determines the level of income inequality in the country, with the South African inequality index having steadily risen from 1994 to the present 0,63, proclaiming South Africa one of the most unequal countries in the world (Sulla & Zikhali, 2018:xv). The Gini index is an indication of income inequality where a coefficient of 1 represents perfect inequality and a coefficient of 0 denotes perfect equality. Similarly of importance when considering vertical equity is the Pareto Optimality principle where cost-benefit analyses are deliberated by Pareto, Kaldor-Hicks and various anti-utilitarian economists in Section 4.4.3, inferred the importance of this concept to both efficiency and equity although political factors may influence the outcome. The Pareto principle highlights the 80/20 rule which maintains that 20 percent of the invested input is responsible for 80 percent of the output (Kaplow, 1995:498; Posner & Adler, 1999:170).

Fairness, although a significant goal of tax reform policy, should not be considered in isolation or more worthy than other economic factors. An analysis of fairness (Section 4.5) revealed a multidimensional concept (Che Azmi & Perumal, 2008:12) with just and equitable tax policies promoting a state of optimal taxation.

Optimal tax theory (Section 4.5.1) should initially focus on tax type and its associated tax rates (Gentry, 1999:307) to ensure the minimization of efficiency costs while maximizing revenue collection (Infanti, 2008a:1204; Sandmo, 2005:644). Modern optimal tax theory tends to deviate from the original adoption which dealt with labour income by including all income irrespective of source (Gentry, 1999:308).

### **7.4.3 Other Factors**

While investigating the economic principles of equity, efficiency and fairness, the administrative importance together with compliance issues of tax systems were unearthed as impacting on equity considerations. Compliance (section 4.6) or non-compliance by taxpayers leads to an array of difficulties for tax policymakers. Most jurisdictions employ voluntary compliance methods unintentionally encouraging tax evasion and avoidance (Bishop *et al.*, 1999:2). Noncompliance by taxpayers propagates tax evasion which diminishes the total tax revenue collected reducing the governments' ability to operate effectively and provide adequate services (Basilgan & Christiansen, 2014:77), a phenomenon particularly prevalent in developing countries (Chau & Leung, 2009:34). Bishop *et al.* (1999:4) observed that non-compliance further resulted in horizontal inequity caused by "tax cheating". However, a diminishing tax base and discriminatory tax policy due to non-compliance also affects vertical equity, efficiency and fairness.

Tax evasion and avoidance (Section 4.6.2), two phenomena that are "inseparably bound up with the instruments of fiscal control that the government attempts to use in carrying out its economic policy" (Cowell (1990) cited in Cummings *et al.*, 2009:3) instigate the growth of an underground economy where a separate economy exempt from the shackles of tax liability operates. The shadow economy adversely affects economic indicators giving rise to distortionary fiscal and monetary policy decisions (Frey & Schneider, 2000:1). Growth of the shadow economy (Section 4.6.3.2) can be attributed to a rise in the burden of tax rates and regulations, perceived unfairness of tax systems, early retirement, unemployment and tax morale (Schneider & Enste, 2000:82).

Another important indicator of equity is tax incidence (Section 4.6) described as "the study of the effects of tax policies on the distribution of economic welfare" or simply portrayed as who bears the economic burden of taxes, (Fullerton & Metcalf, 2002:1789; Kotlikoff & Summers, 1987:1043; Slemrod & Yitzhaki, 2002:1446) provided accurate tax statistics are available. Tax reform proposals, especially in developing countries, should strive to achieve the objectives of economic neutrality, horizontal equity and tax simplification (Dom & Miller, 2018:10; Thirsk, 1991:58) while aiming to maximize revenue collection and reducing the size of the shadow

economy. Developing countries are usually plagued with high levels of informal trade, limited administrative capacity and unique difficulties that require careful consideration (Bird, 2003:15; Sokoloff & Zolt, 2007:131).

In light of the importance placed on equity, historically and economically, coupled with its associated economic and non-economic influences a study of the current South African income tax system was necessitated in Chapter Five.

## **7.5 Equity in The South African Context**

From the preceding discussions it is clear that the South African tax system should be economically principled and well administered while maintaining the principles of equity, efficiency and simplicity as described by economists past and present. The Income Tax Act (58 of 1962) should adhere to the rules of transparency to successfully broaden a fairly undersized tax base. In ideal circumstances, taxpayers should be encouraged to avoid illegal measures to evade tax which will ultimately broaden the tax base and increase revenue while being economically beneficial (Avi-Ronah, 2006:3; Dom & Miller, 2018:12). The impact of poor economic growth has resulted in an ever increasing tax burden for the State due to extensive levels of unemployment with the absence of fiscal consistency that began to initiate the trend where taxpayers sought to either evade or avoid taxation (Tanzi, 2006:12).

Chapter Five explored the principles of equity, efficiency and effectiveness in relation to the current South African tax system. Although the South African income tax system levies various taxes, Tanzi (2004b:534) emphasised the importance of value-added tax (excluded from this study) and personal income tax which he described as the 'workhorses' of the South African tax system. Tanzi (2004b:534) further emphasised the reliance placed on revenue collected from natural persons in present day South Africa.

### **7.5.1 Current Tax Legislation**

At the outset the definition of gross income is of fundamental value to the assessment of equity as income forms the foundation of any income tax system irrespective of the definition used. The present comprehensive definition of gross income (Section 5.3), which is applied to all taxpaying entities can be considered equitable however Hungerford (2006:11) revealed the use of deductions and allowances (Section 5.3.1) or tax expenditure tend to compromise progressivity and the effectiveness of a tax system. The tax expenditure tends to reduce the taxable income with various critics questioning the objectives and administrative costs of implementation. These preferential allowances result in revenue loss to the discus (the State coffers) (Hungerford, 2006:4) which in the 2014/2015 year of assessment amount to R139,1

billion or the equivalent of 3,6 % of GDP (National Treasury, 2017:127). Swift (2006:1) noted incentive allowances are favoured in developed rather than developing countries as a proliferation of tax expenditures tend to encourage tax evasion and an amplified shadow economy in developing countries. An unexpected consequence of tax expenditure could result in the obstruction of vertical equity with diminished progressivity (Barrios *et al.*, 2016:2) while an increase in the number of allowances and deductions, if not advanced to all taxpayers in that income class would adversely affect horizontal equity principles. Although economic principles are significant, Muller (2010:49) established equity considerations in South Africa tend to follow political norms rather than economic principles which influence tax policies including tax rate structures, choice of tax bases and special incentives.

At least two tax commissions were established post democratic elections in 1994 with the Katz Commission of Inquiry into Taxation (Katz Commission)(Section 5.7.1) being the first. South Africa's tax authority was awarded autonomous status in 1997 on recommendation from the Katz Commission (The Davis Tax Committee, 2017:7), with this transformation resulting in an improvement in the administration of tax while reducing the compliance costs incurred by the revenue collector without having a similar effect on the taxpayer. Although these changes herald positive efficiency attributes, the plethora of deductions afforded to certain taxpayers encourages tax evasion and avoidance. Taxpayers either realise the complicated structure of the tax system is time consuming resulting in an increased underground economy or they take advantage of tax arbitrage opportunities, either domestically or internationally, thereby attempting to decrease their taxable liability (Bird & Zolt, 2005b:1634). Steenekamp (2012:51) reiterated the opinion held by McCaffery (1999:251) vis-à-vis tax systems, particularly the South African tax system, which encourages taxpayers to structure their tax affairs to manipulate deductions, allowances and after-tax rate differentials encouraging tax arbitrage and avoidance resulting in the tax burden being unduly falling on the middle class. This further affects horizontal and vertical equity principles adversely. The Katz Commission's foremost concern was the significance placed on personal income tax with the coexisting minute tax base (Aaron & Slemrod, 1999:8; Steenekamp, 2012:44) and subsequently the lack of fundamental tax reform. A further concern is the unfavourable view of progressive income tax systems which is employed in the taxation of individual taxpayers, in the economic arena of late (Dom & Miller, 2018:16).

A significant portion of total revenue is currently obtained from individual taxpayers with corporate tax collections playing a secondary role, an occurrence noted in developed rather than in developing countries (Tanzi & Zee, 2000:307). Bird and Zolt (2011:1691) echoed these views but noted the share of revenue collected from individuals in developing countries has

decreased over a twenty year period (Section 5.5.2), contrary to the South African situation. To rectify this a review and overhaul of the personal income tax system in South Africa is crucial especially in light of the favourable tax regimes of neighbouring South African Development Community (SADC) countries.

The Davis Tax Committee was appointed in response to the 2008 global financial crisis to analyse and advise on the impact of tax reform methods on economic growth and revenue collection (Section 5.7.2). The Davis Tax Committee (2016:8–9) reported of attitudes towards the South African Tax system varying from being viewed as “a coercive, extractive exercise of predatory state power, essentially to maintain the status quo favouring powerful interest groups” to being the redistributive mechanism that enhances social justice and nation building to an instrument that corrects market distortions and stimulates growth. Although constitutional, political, socio-economic and policy factors affect the articulation of tax policy amendments, the ability-to-pay and benefit principles coupled with perceptions of fairness and tax legitimacy are crucial (The Davis Tax Committee, 2016:13–14). The Davis Tax Committee concurred with the National Development Plan 2030 findings in respect of the tax base where it was stated: “there clearly would not be enough tax payers [sic] and contributors to ensure state provision, maintenance and sustainability of decent social protection” (National Planning Commission, 2012:366) (Section 5.7.3). This poses a further potential economic and political dilemma for the State with the need to broaden the tax base being at the forefront of this argument.

In the present climate the need to maximise total revenue is vital (Tanzi & Zee, 2000:301), with The Davis Tax Committee both in 2014 (11) and 2016 (11) forwarding a number of reasons which led them to believe the current South African tax system is plagued with inequities (section 5.4) resulting in distortions associated with lower economic growth (Arnold, 2008:5). Validation of the Davis Tax Committee conclusions are confirmed by the statistics relating to revenue collection for the past ten years where collection from personal income tax has risen steadily on an annual basis (Section 5.5) resulting in this being the principal source of revenue in the country.

The basic objectives of adequate revenue-collection, redistribution of resources, correction of market failures and economic policy influencing behavioural responses coupled with international competitiveness are of utmost importance (The Davis Tax Committee, 2016:13–14) and need to be adhered to while respecting the economic principles of equity, efficiency and fairness. The Davis Tax Committee (2016:10) report reiterated tax reform policies need to comply with these basic economic concepts while achieving a transparent, simple and legally acceptable tax system. Furthermore broad-based tax structures, efficient administration of tax

systems and effective enforcement of tax laws exert a positive influence on long term economic growth (Engen & Skinner, 1996).

### **7.5.2 Tax Reform Challenges**

Tax reform in South Africa faces various challenges resulting from its infrastructure, political affiliations, massive unemployment levels and poverty (Bird, 2003:17). A particularly large agricultural sector which is difficult to tax and a large shadow or informal sector creates a potentially unreachable tax base with unique limitations when tax reform measures are being considered (Bird, 2003:17; Di John, 2006:3). The Davis Tax Committee (2014:12) recognised the daunting task of formalising a growing informal sector, a fairly large agricultural sector and lower than normal literacy rates faced by South African lawmakers. Additional concerns are the persistently high level of inequality inherent in the Income Tax Act (58 of 1962 as amended), the need for economic growth and the issue of job creation (Lewis & Alton, 2015:7) (Section 5.8).

Globalisation has prompted capital mobility with domestic investors seeking the highest rate of return on international markets (Swank & Steinmo, 2002:645) thereby shrinking the already depressed economic market (Section 5.8.2). In addition to the effects of economic factors, non-economic influences affect the efficient and effective operation of the South African tax system (Section 5.8.5). An additional destabilizing factor in South Africa has been the corruption indignities that have flourished recently augmenting the perception of inequity, inefficiency and lack of good governance with Awasthi and Bayraktar (2014:2) validating the establishment of good governance to ensure and maintain a corruption-free tax administration (Section 5.8.8).

There is no doubt that tax structures in South Africa are administratively complex, non-responsive to growth with discretionary policy measures raising limited revenue while introducing economic distortions, and inequities (Bird & Zolt, 2005a:1629; Khalilzadeh-Shirazi & Shah, 1991:xvi). Ahmad and Stern (1989:1016) advise that tax lessons should be learnt from less developed countries with similar challenges rather than from developed countries as direct taxation requires proper design, administration and effective implementation, a view reiterated by Dom and Miller(2018). This dilemma may be addressed by effecting tax reform policies that involve a comparison of the revenue, deadweight loss and distributional consequences (Feldstein, 2008:132) while ensuring the maintenance of equity and fairness principles. However, as noted by Tanzi and Zee, (2000:306) the achievement of optimal taxation in developing countries is hindered by many economic setbacks and political upheavals with recent suggestions of adopting custom built tax reform measures that respect the peculiarities of the developing country (Bird & Zolt, 2005a:1695; Dom & Miller, 2018:24) .

With a tax system that advances the policies of a developed rather than a developing country coupled with other economic and non-economic impediments, it is imperative to consider tax reform policies that would enhance economic growth while broadening the tax base (Section 5.8.4) as initially noted by the Katz Commission.

**7.6 Tax Reform Policies and Suggestions**

The primary objective of any tax reform process (Section 6.1) should be to facilitate an increase in revenue while encouraging economic growth to raise standards of living (Krivka, 2006:73). This can be achieved in some fair way without increasing inflationary pressure to ensure political stability (Bird & Zolt, 2005a:1630) particularly in developing economies. The ultimate goals of tax reform, however, involve the collection of sufficient revenue in an equitable and efficient manner, goals which are often but not always mutually reinforcing (Gray, 1989:2) particularly in developing economies.

**7.6.1 Goals of Tax Reform**

The previous chapters highlighted the importance of economic and non-economic taxation principles. Taxation goals, particularly in a developing country like South Africa, should endeavour to attain the maximum possible economic goals when considering tax reform measures. Table 7-1 has been compiled to summarise the most important goals of tax reform highlighting the functional capabilities of equity, efficiency and simplicity, topics discussed in Chapter 4. Equity, efficiency and simplicity goals are clearly understood except for the reduced tax on investment income under efficiency which precludes any double taxation resulting in improved efficiency.

**Table 7 - 1: Goals of tax reform**

<b>GOALS OF TAX REFORM</b>		
<b>EQUITY</b>	<b>EFFICIENCY</b>	<b>SIMPLICITY</b>
Impose equal taxes on similar income	Reduced tax on investment income	Simple, easy to understand
Lower income group has no/ low taxes	Tax policy should promote economic growth	Efficient tax planning and enforcement
Fewer tax brackets to control the overall tax burden	Reduced tax administration costs	Reduced errors in tax administration and compliance
Equal treatment of citizens from a tax perspective	Reduced tax compliance costs	Reduced potential for tax avoidance and evasion

(Source: Author)

Tax reform methods differ from country to country with major tax reform policies necessitating certain measures particularly for developing economies. Various alternate tax reform models have been identified, proposed and implemented where the emphasis has been on simpler, fairer and economically efficient tax systems that are globally competitive (Nellen & Porter, 2016:7). Chapter Six explores these personal income tax reform systems and the implementation successes and failures of the most prominent of these.

The twentieth century has seen numerous tax reform proposals, many of which have not been implemented (Section 6.2). The most popular movement was the flat, dual rate income tax which was first adopted in Hong Kong in 1947 (Section 6.5.2). The flat rate tax concept was revived by the American economists t Hall and Rabushka in the early 1980s when they presented a consumption type flat rate tax system (Sections 3.8.9 and 6.4.1). The benefits of the flat rate consumption tax included the provision of incentives for capital formation through investment write-off, its simplicity and its uncomplicated administrative process (Hall, 2005:5). However, the shortcomings (Section 6.3.3.1) of this tax reduced the tax burden for lower and higher income groups at the expense of the middle income earners as Hall and Rabushka did not calculate the effects of inequality (Vionea & Mihaescu, 2009:22). This sparked a debate relating to consumption type taxes versus income based taxation with Zelenak (1999:209–211) establishing that a consumption based tax is not superior to an income based tax and a flat rate tax with no exemptions would be more efficient than the Hall-Rabushka tax with a basic exemption. The only country that adopted the flat rate consumption tax was Croatia (Section 6.5.2) with an initial adoption in 1994, followed by this being abandoned in 2001 to be reintroduced in 2005.

### **7.6.2 Flat Rate Income Tax**

The flat rate consumption tax was modified by numerous jurisdictions resulting in the implementation of a flat rate income tax by predominantly Baltic previously socialist economies (Section 6.5 and 6.6) also referred to as transition economies . Although critics of the flat rate income tax continued to dismiss the adoption of the flat tax as a “temporary fad” most jurisdictions that adopted this reform have retained it (Edwards & Mitchell, 2008:59–60). The flat rate income tax succeeded in preserving the traditional requirements of an effective tax system; simplicity, efficiency and fairness while collecting the required funds needed by government (Greco, 2004:10) in the countries that implemented it (Section 6.8).

Section 6.5.1 further highlights the different categories employed by various jurisdictions during the implementation period. Although income was the common tax base with a single rate tax,

the discrepancy in the allowances resulted in the tax system being regarded as either progressive, proportional or negative (Blazic, 2009:2).

Traditionally the flat income tax rate did not exceed twenty percent with the contemporary adoptees discussed in Section 6.5.2 with Table 6-3 portraying the flat rate income tax adoptions with their pre-reform and post-reform tax rates. The influence of the Laffer Curve has been emphasised during the flat tax adoptions with this being discussed in Section 6.3.1 with notable mentions in Section 3.3.1 during the Kautilyan age and Section 3.3.4.2 when Khaldun discovered that raising taxes would actually decrease tax revenue (Ahmad, 2015:15; Chapra, 1999:27).

Contemporary initial adoptions of the flat rate income tax occurred during the early 1990s with a revival of interest in the concept after the Russian adoption in 2001. The introduction of the Russian flat rate income tax swayed the discussion relating to tax cuts and tax revenues. Russia's flat tax reform (Section 6.6.3) was quite revolutionary for a large country as the entire tax administration structure was reviewed along with the change in tax rate as part of a wider package of tax reforms (Gorodnichenko *et al.*, 2007:2; Keen *et al.*, 2006:5). The aim of Russian tax reform was primarily to broaden the tax base and eliminate tax evasion opportunities by introducing a flat income tax at a rate of 13 percent. The Russian economy responded favourably to these factors encouraging growth with unemployment levels and poverty that more than halved during the period from 1999 to 2008 (Djankov, 2015:3). The flat rate income tax became a stable feature of the Russian economy contributing to a culture of compliance, a decline in capital flight and increased fiscal revenue (Rabushka, 2006:1), initiating an awareness that resulted in a second wave of adoptions (Section 6.6.4). A notable adoptee in 2007 was Mauritius, a close neighbour and trading partner of South Africa (Section 6.7.3).

### **7.6.3 Tax in Africa**

Although independent Africa inherited high poverty rates, massive unemployment and underdevelopment of infrastructure (Sebudubudu & Mooketsane, 2016:145) it is furthermore notorious for its political unrest and economic mismanagement. With this structure African tax systems (Section 6.7.2) should primarily emphasise the redistributive role of taxation due to the substantial levels of poverty and unemployment. Certain African jurisdictions, however, enjoy favourable and economically successful tax systems with these being discussed in Sections 6.7.3 and 6.7.4.

Mauritius (Section 6.7.3), a historically agricultural country, like most developing countries in the region, launched a wide range of reform processes (David & Petri, 2013:3) which included the

introduction of a flat rate income tax of 15 percent in 2007 on both corporate and personal incomes which helped streamline the tax administration process (Zafar, 2011:97). The flat rate income tax system of 15 percent was accompanied by zero taxation on capital gains and dividends for residents which are also valid for international companies making it an attractive investment destination (Joseph & Troester, 2013:53). This favourable tax system has enjoyed tremendous success increasing both domestic and foreign direct investment.

Successful tax systems are not limited to flat rate income tax reform but may encompass systems geared towards achieving the primary goals of tax. Although not a flat rate income tax regime, Botswana with its rapid growth that can be attributed to an open economy, a considerable degree of foreign capital and a stable currency (Armah, 2015:11) begs consideration due to its proximity to South Africa. With economic growth that is comparable with Mauritius the adoption of favourable not flat tax rates encouraged foreign direct investment in Botswana (Sebudubudu & Mooketsane, 2016:151). The corporate tax rate is fixed at 15 percent with individuals being taxed at the highest marginal rate of 25 percent with the first 36 000 Botswanan pula, the equivalent of R49 320 (as at 27 October 2018) being exempt from tax. Although not strictly a flat rate of income tax, the highest marginal personal income tax rate of 25 percent is rather favourable when compared to the South African top marginal personal income tax rate of 45 percent.

#### **7.6.4 Economic Reactions to the Flat Rate Tax**

The adoption of flat income tax rates in various jurisdictions has been met with mixed reactions from proponents and detractors of the system. These highlights and shortcomings are discussed at length in Section 6.8.1 with the economic consequences of implementation being examined in Section 6.8.2. Although Blazic (2009:5) noted a rise in revenue collection post implementation this could moreover be attributed to increased compliance due to improved administrative capabilities that usually accompanies a simpler tax system.

Equity concerns (Section 6.9.1) have been satisfied according to Keen *et al.* (2008:722) who believed both horizontal and vertical equity will be achieved if a basic personal exemption is incorporated when a proportional tax is adopted. Saavedra (2007:255) argued a flat rate income tax would minimize the effects of tax arbitrage, which is the shifting of tax liability from higher-taxed category of income to lower-taxed category of income thereby improving efficiency (Section 6.9.2) of the tax system. However, if there are no exemptions in place for lower income earners, proportional tax rates may have an adverse effect on vertical equity and efficiency (Sciaou & Moga, 2009:344). Certain economists have expressed concern relating to the lack of

progressivity of the flat rate income tax while others have contended this effect is negated as untaxed income is included in the tax net (Norregaard & Khan, 2007:28).

When equity and efficiency principles are considered policy-makers need to establish their primary objectives with respect to the implementation of tax principles and the choice between an income or a consumption tax (Section 6.9.3), its effects on equity and efficiency and its resultant influence on total revenue collected is vital. Norregaard & Khan (2007:30) maintain that the equity impact of flat tax implementation is less adverse than it appears.

Coupled with equity, efficiency fluctuations need to be considered with Greco (2004:5) highlighting the loss of efficiency created by progressive tax systems raising the barrier against working extra hours, reinvesting and saving (Section 6.9.2). Progressive tax systems may exceed the maximum allowable tax rate on the Laffer Curve resulting in a decrease in total revenue collected (Greco, 2004:5).

Personal income tax, when viewed against the current South African tax landscape, reveals an inequitable burden being placed these collections (Section 6.9.4) (Stats SA, 2019:2), necessitating tax reform considerations.

#### **7.6.5 Dual Income Tax**

Section 6.10 introduces a supplementary tax reform suggestion in the form of a dual income tax system employed by certain Nordic countries who levy a progressive tax rate on labour income while levying a flat rate tax on any income earned from capital investments (Diamond & Zodrow, 2006:2). Kleinbard (2010:43) defined a dual income tax as a two rate schedule tax where capital income is comprehensively defined and taxed at one relatively low proportional (flat) rate and labour income is taxed under a separate progressive schedule. Reducing effective tax rates on investments may result in an increase in domestic investment and a probable increase in foreign investment depending on returns and tax rates in neighbouring jurisdictions (Liebfritz *et al.*, 1997:11) with enhanced effects on equity and efficiency as highlighted in Figure 7-1. Keuschnigg and Dietz (2005:3) believe a dual income tax is a compromise that aids in limiting the taxation of capital income while fulfilling the requirements of both equity and efficiency principles. Table 6-5 highlights the advantages and disadvantages of the dual tax system.

#### **7.7 Recommendations**

Globalization has resulted in an integrated economy which allows for the migration of human capital across national borders resulting in increased tax competition due to the expectation of investors being allowed to relocate to countries where their returns are maximised and their

taxes are minimized (Edwards & Mitchell, 2008:15). This phenomenon directly affects equity and efficiency of the tax system coupled with loss of revenue particularly within the confines of the African continent. As tax reform processes likewise directly affect economic growth (Myles, 2000:141), the search for the critical balance between tax base and tax rate is vital to ensure an economically viable and reliable tax system to achieve various economic goals. This necessitates the implementation of pro-growth reform with lower tax rates to reduce the discriminatory burdens on savings and investments, which will result in a healthier fiscal climate that attracts capital investment from other countries while reducing the movement risk of domestic taxpayers (Mitchell, 2007:11).

South Africa being regarded as one of the more successful economies in Africa (National Treasury, 2017:15), although this view may have diminished over the past couple of years, should be at the forefront of tax reform. However, high levels of corruption, bureaucratic red tape and poor governance have resulted in poor compliance by taxpayers (Tanzi, 2006:12). South Africa's quest for stability, prosperity and good governance would benefit from a fair, equitable and efficient tax system that would highlight the perception of fairness to encourage compliance among its citizens. Although the levels of tax administration have improved (The Davis Tax Committee, 2016:21), the levels of compliance have decreased due to negative attitudes and perceptions by the citizens of South Africa effectively reducing the already minute tax base (The Davis Tax Committee, 2014:3).

The current highly progressive personal income tax rates refute the Laffer Curve principle, a view similarly held by historical and contemporary economists, which prescribes a reduction in personal income taxes would improve tax collection and broaden the tax base (Steenekamp, 2012:48). Although the OECD (2010:98) recommended an increase in personal tax rates globally to offset the adverse effects of the 2008 global financial crisis, the raising of the top marginal tax rate in South Africa from 40 % to 41 % and further to 45 % did not yield the desired results. The Davis Tax Committee (2016:26) report further observed that the highly progressive PIT system does not reduce income inequality significantly, a view recently reiterated by Dom and Miller (2018). Compared to other developing countries, personal income tax rates are very high with a proven ineffective distribution of income irrespective of the tax reform applied over the past two decades (Steenekamp, 2012:53). High progressive personal income tax rates do not ensure decrease in the level of inequality in developing countries (Bird & Zolt, 2005a:1650). Although the Davis Tax Committee expressed concern regarding the maximum applicable tax rates and the arbitrage opportunities that exist between the PIT and CIT maximum tax rates with more affluent taxpayers diverting income into corporate structures to benefit from the favourable rates and incentives afforded to corporate structures, arbitrage opportunities also exist between

countries with more favourable tax regimes. The movement of income to lower taxed vehicles or internationally, adversely affects equity principles and subsequent tax reform measures. The above findings necessitates an overhaul of the current personal income tax legislation with further arbitrary factors that need to be considered.

Personal income tax reform measures should similarly consider:

The individual deciding where to live will take into account the private effects upon him of the bundle of government services and taxes. (Tullock, 1971:917)

Personal income tax reform in South Africa should be undertaken with the following factors being considered:

- The basic economic tenets of equity, efficiency, simplicity and transparency factors,
- The non-economic factors that affect economic principles,
- Globalisation and tax arbitrage opportunities that may exist.

Tax reform recommendations based on this study:

- a growth maximising level of taxation as high personal tax rates are counter-productive if these revenue maximising levels result in economic impairment, a view verified by Bird & Zolt (2011:1691).
- The high progressive personal tax rates render tax reform imperative when the previously discussed factors and the economic findings are considered. However a flat rate income tax reform (Section 6.5), although consistent with the requirements of the present economy, would prove too drastic for the South African economy due to the huge discrepancy between maximum marginal personal income tax rates and the corporate tax rates, a point reflected on by the Davis Tax Committee. The maximum marginal personal income tax rates need to be reduced gradually, consistent with the principles of the Laffer Curve, which would condense any arbitrage opportunities that exist both locally and internationally and broaden the tax base.
- The comprehensive study of alternate tax systems in Chapter 6 highlighted the benefits of increased compliance and efficiency coupled with administratively simple and transparent tax policies. The application of these resulted in increased revenue, administrative efficiency and economic growth. With the most popular tax reform being the implementation of a

version of the flat rate tax, careful consideration of this is imperative for the present South African tax system.

- The importance of a simple, transparent, equitable tax system may be achieved by comparing tax reform jurisdictions and their successes and failures. The implementation of a dual income tax system should also be considered initially as this would encourage domestic and foreign investors to retain capital in South Africa while acting as a stimulant for the economy. Steenekamp (2012:54) noted that while the dual income tax provides the progressivity needed to enhance vertical equity, it boosts investment income and has the advantage of complying with horizontal equity requirements.
- As South Africa needs to rise to the challenge of competing with politically and economically stable neighbouring countries, a transparent, equitable, efficient and fair tax system should be enacted. The tax system of Botswana provides a model where the maximum marginal personal income tax has been successfully reduced resulting in increased total revenue collection while the flat rate tax system implemented by Mauritius has proven extremely favourable.
- An improvement in revenue collection and expansion of the economy with much needed foreign and local investment opportunities is mandatory. An empirical study of suitable revenue maximising income tax rates needs to be performed to ascertain the appropriate tax rates that will maximise revenue and enhance economic growth as high income tax rates have an adverse effect on economic growth and revenue collection (Besley & Persson, 2014:109).

## **7.8 Topics for further research**

The primary study of equity highlighted various economic and non-economic factors that affect equity considerations which were too vast to incorporate in this research and the dire need for an overhaul of the personal tax system in South Africa.

Areas for further research would include:

- A study of the Laffer Curve effect particularly in relation to the current Income Tax legislation and its impact on personal income tax to ascertain a revenue enhancing tax rate.
- The effects of high tax rates on tax compliance and the shadow economy with an empirical study on the size of the shadow economy in South Africa. Although this may prove difficult to ascertain accurately, a reasonable estimate will be of assistance.

- The consequences of non-compliance on total tax revenue from both corporate and personal income tax and its subsequent effect on revenue collection.
- The correlation between corruption, compliance indicators and its ultimate outcome on tax revenue.
- The impact the current tax regulations have on local and foreign direct investment.
- A study of the effects of globalisation tracking personal wealth across borders.
- A determination of the precise flat/dual rate to be implemented.

In conclusion, it is important to ensure an equitable tax system to improve economic growth while collecting adequate revenue to effectively manage the country. Personal income tax rates in South Africa need to be revised to attract foreign and domestic investors and ultimately increase the tax base. Tax reform procedures pertaining to natural persons, should be just, equitable and transparent encouraging compliance. However, the revenue maximising tax rate and base, its proportionality or progressivity needs to be further investigated.

When considering tax reform principles Bird and Zolt (2005:1649) noted with interest that:

No country is a tax island that stands alone either outside its own history or its current context. Fiscal policy, like other policy change, is thus more evolutionary than revolutionary.

On the other hand, it must also be noted that there is no 'one-size-fits-all' tax system (Bird & Zolt, 2005; Dom & Miller, 2018) necessitating careful and prudent tax reform policies in South Africa.

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