

TAX REFORM: AN OVERVIEW OF THOUGHT FROM RELEVANT LITERATURE

Panel discussion ERSA workshop

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What drives tax reform?

1. **Rising fiscal deficits** with increased tax burden – **broadening the tax base** - tax structures to be adjusted accordingly.
2. **Lower tax rates** – globalisation with increased tax competition .
3. **Ideal** – a proper fit with **unnecessary tax distortions eliminated**.
4. **Minimizing** economic and administrative **inefficiency** – tax structures have to be as **simple and transparent** as possible - avoiding arbitrary tax differentiation across people and forms of economic activity.
5. **Progressiveness and neutrality** – vertical /horizontal.
6. A **reappraisal of the redistributive role of income taxes** – both vertical and horizontal equity an elusive goal – tax not allocatively neutral – causes distortions
7. More emphasis on **expenditure policies** to achieve this goal.



Comparisons - general observations

	Africa emerging countries	South Africa	Asian emerging countries	Developed countries	European emerging countries	Latin American countries	Middle East countries
Variable	Mean % of GDP	% of GDP	Mean % of GDP	Mean % of GDP	Mean % of GDP	Mean % of GDP	Mean % of GDP
Tax from income and profits	6.35	16.58	4.14	11.52	4.28	6.15	3.07
Payroll tax	0.28	0.32	0.04	0.23	0.09	0.74	0.10
Property tax	0.50	0.41	0.22	0.67	0.05	0.83	0.15
Consumption tax	7.63	8.71	6.82	9.37	12.46	8.24	1.65
Tax on Trade	7.94	0.99	2.84	0.19	1.33	2.18	1.86
Other tax	0.19	0.02	0.10	0.22	0.30	0.24	0.14
Total Tax	22.89	27.03	14.15	22.20	18.51	18.16	6.97
Social contributions	2.24	0.55	0.16	8.69	9.55	3.07	1.23
Grants	0.96	3.21	3.18	0.39	1.01	0.58	0.32
Other Revenue	6.17	0.54	7.02	3.67	3.43	4.62	26.34
	% of total tax	% of total tax	% of total tax	% of total tax	% of total tax	% of total tax	% of total tax
Tax from income and profits	27.8%	61.3%	29.2%	51.9%	23.1%	33.9%	44.0%
Payroll tax	1.2%	1.2%	0.3%	1.0%	0.5%	4.1%	1.4%
Property tax	2.2%	1.5%	1.6%	3.0%	0.3%	4.6%	2.1%
Consumption tax	33.3%	32.2%	48.2%	42.2%	67.3%	45.4%	23.7%
Tax on Trade	34.7%	3.7%	20.1%	0.9%	7.2%	12.0%	26.7%
Other tax	0.8%	0.1%	0.7%	1.0%	1.6%	1.3%	2.0%
Total Tax	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: GFS 2008

General observations

- Tax on **Income and profits** – SA at a relatively higher level than the **mean** for other groups of countries.
- **Trade tax in SA low** compared to Africa emerging countries and Middle East countries.
- Share of **tax on goods and services** - SA in line with Africa but lower than rest.



Personal Income Tax



- Trend is to **simplify income tax structures** – flattening the tax rate structure.
- Minimising the **tax wedge** - studies attempt to estimate the impact of **tax on employment**.
- **Tax rates** at higher income levels and **structural progressivity** adjusted downwards – new look at the **complexity** of national tax systems.
- The relationship between **tax rates** and **revenue collected** positive for higher income countries but declines in the case of lower income countries and weaker institutions.

Bahl, R.W. and Bird, R.M. 2008. Tax Policy in Developing countries: Looking back - and forward, *National Tax Journal*, vol. LXI, no. 2

Gallagher, M. 2010. Labour taxation and unemployment: an empirical investigation. *USAID*.

Sabirianova, P. *et al.* 2010. Global reform of personal income tax . *National Tax Journal*, 63(3).

Introducing flat taxes?

- Some countries (mainly former have adopted flat personal taxes on labour income featured by **high social contributions**.
- Low rates but overall effective rate quite high - these **high tax wedges** remain a significant **policy concern** in many flat tax countries.
- Mostly part of a **wider package of tax reforms** - often include attempts to improve tax administration.

The future?

- Not merely flatness but a **low rate** is important.
- The lessons that can be drawn are limited – Apart from Russia, the second wave of low-rate flat tax reforms associated with a **reduction in revenue**.
- The impact of the flat tax on work incentives not clear-cut - no strong evidence of impact on **work effort**.

Keen, M, Kim, Y and Varsano, R. 2008. The flat tax(es): principles and experience. International Tax and Public Finance, vol.15, no. 6, pp 712-751.



Corporate Income Tax

- **Globalisation** and **capital mobility** – **less reliance on CIT** - capital moves more freely across countries in response to relatively small changes in interest rates and tax rates.
- Seeking FDI - developing countries have to **align their tax rates**. Rather provide preferential tax treatment for foreign vs. domestic corporations.
- A **drive to the bottom** (Oates, 1972:143) could cause **fiscal externalities** (spillovers) – market failures due to lack of government support (maintenance).



Bahl, R.W. and Bird, R.M. 2008. Tax Policy in Developing countries: Looking back - and forward, *National Tax Journal*, vol. LXI, no. 2

Corporate Income Tax (Continued)

- *Stylised facts:*
- 1: **Statutory tax rates on the decline** - pace of reductions varies.
- 2: The **effective average tax rates** for projects earning positive economic profits **have fallen** continuously since the early 1980s.
- 3: On average, **weighted by GDP, tax revenues on corporate income broadly stable** as a proportion of GDP. However, the unweighted average on the increase.
- 4: On average, weighted by GDP, **tax revenues on corporate income have declined as a proportion of total tax revenue since 1965.**

Devereux, M.P. and Sørensen, P.B. 2006 *The corporate income tax: international trends and options for fundamental reform*. European Commission Economic Papers, no. 264



Fiscal decentralisation

- Mostly **decentralized expenditure** delivery with **tax sharing**.
- Decentralisation of **functions excelled** but **revenue sources lagged** – Governments **reluctant to release taxing powers** to sub-national spheres.
- Mostly financed through **transfers** – own revenue comprises of **levies** on services and **property tax** of which importance is on the increase.
- Challenge: **Central taxes have reached a ceiling**
 - To expand the tax base tax powers have to be **decentralize d** – **include** individuals and institutions currently outside the net (especially small firms and owners of immovable property).
 - Hypothesis: sub-national governments have the potential to **reach below-threshold payroll, consumption and real property wealth**.

Bahl, R.W. and Bird, R.M. 2008. Tax Policy in Developing countries: Looking back - and forward, *National Tax Journal*, vol. LXI, no. 2



Taxes on goods and services

- **Trade liberalization** and compliance with World Trade Organization (WTO) rules and trade agreements a **limiting factor on tax reform**.
- **Less reliance on international trade taxes** as tariffs fall - most developing countries faced with the prospect of **offsetting a revenue loss** at least in the short run.
- Way out is to **raise taxes on goods and services** - However, no more than 30 percent of the reductions in trade tax revenues recovered in this way.
- Countries reluctant to cut income tax rates but gradually more emphasis on taxes on goods and services such as **VAT**
- This is disputed – Stiglitz argue that it might **reduce welfare** . Also, trade taxes **cheaper to administer**.

Emran M.S. and Stiglitz, J.E. 2004

Baunsgaard and Keen : 2005)



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Environmental tax

- Up to 5% of GDP - 90% based on **fuel & vehicle taxes** – its share on the **decline!**
- Tax reform on environmental issues consider **taxing the polluter at the marginal external cost rate** - normally lower cost than regulation.
- **Types** of taxes include **broad-based income tax** and **product specific taxes** including **excises and tariffs**.
- Options investigated **include regulation, tradable quotas, subsidies and the determination of missing property rights**.
- Resource rents – currently taxed via **royalties** – replaced by **resource rent tax?** The role of land tax ?



Future tax reform

- **Low tax-rate jurisdictions** - more **pressure on statutory rates**.
- **How to treat SMME's?** - overlaps with the **informal sector** – favourable presumptive tax systems – more faith than evidence .
- **Tax expenditure programs** – **expensive**. Needs a **sunset clause** – annual estimation – should it be part of the budget?
- **Substitution effect between taxation and corruption** - Tax structure choices should consider:
 - **Increased transparency of taxes; minimize contact** between taxpayers and administrators (**self assessment**) ; **reduce compliance cost ; and increase penalties** for detection.
 - Remove tax differentials that cause tax arbitrage
- **Improved the quality of tax administration.**
- **Re-look at decentralised revenue sources.**

Martinez-Vazquez, Granado and Boex (2007) and Bahl (2006).

