

Reflection on the Ability to Pay Theory of Taxation in the Context of South African Municipalities

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Abstract: This paper evaluates, analyses and reflect on how the theory of the ability to pay and who benefit are applicable to the municipalities. Revenue collection is critical for the survival and sustainability of municipalities. This paper is theoretical in nature and scope and base its argument from secondary literature sources. This paper concludes that the theory of ability to pay is the most applicable in South African municipalities as ratepayers possess the ability to pay rates and taxes despite of the benefits from municipalities in terms of the services they receive. This theory is the direct opposite in its elements with the benefit theory. The benefit theory or voluntary exchange theory states that individuals which in this instance are municipal residents who benefit the most of municipal services in turn pay more taxes than those receiving minimal services.

Keywords: Ability to pay theory, Municipality, Revenue, Services

1. Introduction

Local government as one of the spheres of government is the constituent through municipalities which is closer to the people. Through municipalities, municipal residents expect municipalities in their areas of jurisdiction to provide them with services as mandated by the Constitution of the Republic of South Africa (1996) and other pieces of legislation. Failure to satisfy this legislative requirement, residents may confront municipalities through service delivery protests in a verge to force their municipalities to deliver services as might have been promised through the Integrated Development Plan and other forums. It is therefore incumbent on municipalities to ensure that they deliver the services as required by the community and promised to the community if it were to retain the trust and confidence. However, it remains the responsibility of municipal residents to ensure that they pay rates and taxes for the service provided to them so that sustainability in service provision can be maintained. Revenue collection is critical for the survival and sustainability of municipalities. This paper therefore attempts to evaluate, analyse and reflect on how the theory of the ability to pay and who benefit are applicable to the municipalities. To do this, the paper provides the literature review in order to locate the article to the broader theoretical framework of the ability to pay theory.

2. The Ability to Pay Theory: A Synopsis

Every research project must be placed in the context of the general body of scientific knowledge; therefore it is important to indicate where this study fits in that picture through the review of literature (Babbie, 1995; Boote & Beile, 2005); wherein literature review should be understood as a critical assessment of what has been done in the past in the given discipline, more in the direction of revision and or consideration (Nkatini, 2005: 26). The ability to pay theory indicates that, every person should pay taxes to the government depending upon his or her ability to pay (Zolt & Bird, 2003:16; Rai, 2004:72; Chodorow, 2008:740; Batt, 2012:70). The insinuation in this theory is that the wealthy class people should pay higher taxes to the government, because without the protection of the government authorities like police and defence, they could not have earned and enjoyed their income that they enjoy. Adam Smith argued that the taxes should be proportional to the income (Zolt & Bird, 2003:16; Rai, 2004:72; Chodorow, 2008:740; Batt, 2012:70). It can therefore be argued that this is one of the critical principles of tax because it advocates for tax to provide equity in its application, wherein those who have the financial resources and the ability to pay should make the payment.

The ability to pay theory propagates that people should be asked to pay taxes according to their

ability to pay and assessment of their taxable capacity should be made primarily on the basis of income and property (Emslie, Davis, Hutton & Olivier, 2001:2; Chigbu, Eze & Ebimobowei, 2012:31). It can therefore be argued that in instances when the low income earners pay tax, that negates the principle of equity as envisaged by Smith (1776) and it further widens the gap between the rich and the poor in the society, invariably further distancing the realisation of income redistribution which the tax systems seeks to achieve. The South African practice of treating indigent differently by giving them certain amount of free water and electricity confirms the application of the ability to pay theory.

In the dawn of democracy, the South African new dispensation was confronted with challenges of providing services to previously disadvantaged groups (Mathebula, 2014). This prompted the need for government to introduce policies that could be used to compensate for the injustices created by the apartheid government. In the local sphere of government, the delivery of some services as a result are provided free of charge to indigent households. This necessitated the development of the indigent's policy. Indigent policies according to Fourie and Opperman (2007), is a policy of dealing with service delivery to poor households, notwithstanding the fact that social welfare is not a function of local government. The welfarist approach of delivering services has in the past put South Africa on the spotlight for making its residents too dependent on the state for all their social welfare needs (Ravallion, 2008). On the other hand Duclos (2002) argues that the poor community cannot be deprived of the right to basic service because of mere affordability therefore, government should create the means to provide for such groups of people. Despite these criticisms South Africa has continued to pursue indigent policies in the local sphere of government for political and other reasons (Fourie & Opperman, 2007). Since municipalities are required to provide some of its basic services without being compensated, providing sustainable services has been a challenge in this sphere of government.

An ideal tax system should also comply with the principle of equality as was reported by Smith (1776:371). The equality principle captures both the ability to pay and the benefit principles which plays a pivotal role in taxation (Martinez-Vazquez, 2001:4; Rai, 2004:58; Batt, 2012:71). The ability to pay principle distinguishes between the horizontal

equality and vertical equality that is embedded in taxation (Rai, 2004:3; 2011:1; Batt, 2012:71). Horizontal equality refers to equality between tax subjects in similar circumstances, whereas vertical equality mandates that tax subjects should bear tax in proportion to their income levels or levels of economic well-being, which implies that the higher the level of economic well-being the greater should be the tax burden (Slemrod, 1990:159; Martinez-Vazquez, 2001:2; Lau, 2003:4; Rai, 2004:3; ITEP, 2011:1). The ability to pay principle is often used to justify the imposition of direct taxation such as a tax on income or tax on capital gains (Martinez-Vazquez, 2001:29; Rai, 2004:58; Batt, 2012:71). It can therefore be argued that the ability to pay theory will ensure that the indigent are not overburdened and are instead given relief through the free services that are afforded to them.

The benefit theory mandates that those who benefit most from the use of commodities or services should be required to pay for the benefit of use (Emslie *et al.*, 2001:12). It can therefore be argued that in the South African context, this theory is not applied, because the quantification of the benefit and the resultant payment thereof will leave the indigent without any service. The benefit principles are therefore used as a justification for the imposition of an indirect tax, such as a value added tax (Martinez-Vazquez, 2001:29; Pfister, 2009:12). The subject of every state ought to contribute toward the support of the government, as nearly as possible, in promotion to their abilities that is in proportion to the revenue which they enjoy under the protection of the state (Emslie *et al.*, 2001:12).

3. The Ability to Pay Approach in the Context of Taxes and Revenue

On the ability to pay approach, the government revenue and expenditures are treated separately and taxes are based on taxpayer's ability to pay and it derives from wealth as well as current income; there is no '*quid pro quo*' (Gaffney, 1971:423; Slemrod, 1994:343; Zolt & Bird, 2003:29; Rai, 2004:58; Chodorow, 2008:697-736; Chigbu, Eze & Ebimobowei, 2012:31; Zhou & Madhikeni, 2013: 49-60). Taxes paid are seen as a sacrifice by taxpayers, which raise the issues of what the sacrifice of each taxpayer should be and on how the measurement of such sacrifice should be done (Rai, 2004:100). The common sacrifices are equal and equal marginal sacrifices and equal proportional sacrifices.

Equal sacrifice, in using this principle, the total loss of utility as a result of taxation should be equal for all taxpayers and the rich will be taxed more heavily than the poor (Young, 1986:204; Rai, 2004:27). For example, if it comes to the payment of tax, because R1 of tax is a small amount for a rich person than a poor person, it will be regarded as correct that the rich person should pay a higher rate than a poor person if all are to sacrifice equally and this means that the rich should be taxed more than the poor. It can therefore be inferred that a person in higher income group should pay more tax than those in the lower income groups. Equal proportional sacrifice means that the proportional loss of utility as a result of taxation should be equal for all taxpayers, which means that everyone forgoes the same percentage of utility in paying taxes (Young, 1986:204-206; Rai, 2004:100). This means that the proportional loss that emanate from taxation should be equal for all the taxpayers. For example, a person earning R20 000 could pay tax of R2 000 and the one earning R10 000 paying R1 000, which means they both make equal sacrifice, even though in terms of the amount the another is higher but they are both 10%.

Equal marginal sacrifice, in this case is the instantaneous loss of utility when determined as a measure by the derivative of the utility function as a result of taxation should be equal for all taxpayers (Rai, 2004:100). This will entail the least aggregate sacrifice which means that the total sacrifice will be the least (Young, 1986:204; Rai, 2004:27). This means that since a person who has a higher marginal utility of income and a person with lower income have a higher utility of income; it therefore means that the rich will pay more taxes than the poor. The economists have put forward many theories or principles of taxation at different times that were used as guidance to the state as to how justice or equity in taxation can be achieved (Rai, 2004:72; Chodorow, 2008:740).

The most popular and commonly accepted principle of equity or justice in taxation is that citizens of a country should pay taxes to the government in accordance with their ability to pay (Zolt & Bird, 2003:16; Rai, 2004:72; Chodorow, 2008:740; Batt, 2012:71; Guj, Bacoum & Limerick, 2013:5). It can therefore be argued and appears reasonable and just that taxes should be levied on the basis of the taxable capacity of an individual, and in using this principle it can be stated that if the taxable capacity of one person is greater than that of the other

person, that a person who earns more should be asked and expected to pay more taxes in comparison with the one who earn less. It can further be argued that if the taxes are levied on this principle as stated above, then justice can prevail and be achieved and the tax burden will then be evenly spread based on the ability of the person to pay such taxes. There are however differences of opinions by economists on the definition of ability to pay. This is mainly on the exact measure to a person's ability or faculty or capacity to pay the taxes (Furman, 2008:8; Batt, 2012:70). It can be argued that it is clear from the discussion of ability to pay approach that taxation emphasises that the amount of tax emanating from an economic activity should be directly proportional to the ability of that particular entity to pay the taxes, conversely a person who is having a higher income should also be taxed more as compared to the person who is having low income. The ability to pay approach have following main viewpoints on which is founded: ownership property, tax on the basis of expenditure, income as the basis proportionate principle, revenue from private income, irregular income and the revenue from state ownership.

3.1 Ownership of Property

Some economists are of the view that, ownership of property can be a good determinant and can therefore be used as the basis for measuring a persons' ability to pay taxes. However, this is not conclusive enough. The notion has been rejected on the ground that it would mean that if a person earns a large income but does not spend it on buying any property, such a person will then escape taxation. It is on this ground that this paper argues that property ownership must not be used as the only determinant for paying taxes (Zolt & Bird, 2003:16; Rai, 2004:58; Furman, 2008:8; Guj, Bacoum & Limerick, 2013:14). It will further mean that if on the other hand another person earning income buys property; he will be subjected to taxation, in which case it will be argued that taxpayers will then deliberately avoid buying property as a way of ensuring that they do not pay taxes. The use of property ownership as the basis for ability to pay taxes is not sustainable and can distort the revenue collection methodologies applicable to South African municipalities and will be unfair to a person who decides to make investment in properties despite the amount of income earned. This on the other hand can discourage people from using their income for the fear of being taxed.

3.2 Tax on the Basis of Expenditure

It is argued that the ability or faculty to pay tax should be determined by the expenditure that a person incurs, which therefore means that the greater the expenditure that a person incurs, the higher should be the tax liability and the converse should hold (Guj, Bacoum & Limerick, 2013:5-14). Although not applicable to South African municipalities, this principle is applied by the central government in terms of the Value added Tax. However, this particular principle has been criticised for being unsound and unfair to the taxpayer as a person having a large family to support will in no doubt incur a larger expenditure in contrast to a person with a smaller family or consumption needs. It can therefore be argued that if the expenditure is used as the test of one's ability to pay tax, then the former person who is already burdened with expenditure and many dependents will have to pay more taxes than the latter who has a small family. This will be contrary to the equity that is supposed to be found in tax and it will be unjustifiable (Slemrod, 1994:2; Zolt & Bird, 2003:16; Rai, 2004:72; Guj, Bacoum & Limerick, 2013:5).

3.3 Income as the Basis for Taxation

Applying this principle would mean that the income should be used as the basis of measuring a person's ability to pay taxes. The use of income as the basis of taxation, on the face value it appears the more justifiable arrangement and fair one. This means that the greater the income of a person the greater the tax. A person who earns a bigger income should be asked to pay more towards the support of the realisation of developmental local government than a person who earns lesser income (Young, 1986:204; Slemrod, 1990:163-164; Rai, 2004:44; Zhou & Madhikeni, 2013:51). This is the same principle of pay as you earn that the South African Revenue Services (SARS) utilises in collecting tax. There is no doubt that South African municipalities can adopt this principle to enhance its tax and revenue collection capacity. This, at least on paper could be the best way of dealing with tax matters because it allows those who are indigent to benefit from those who can afford. It also has an element of cross subsidisation on taxpayers or citizens in different income levels. In the modern tax systems in many countries around the world, this basis of taxation has been accepted as the best test for measuring the ability to pay tax per person (Rai, 2004:58; Guj, Bacoum & Limerick, 2013:14).

4. The Ability to Pay Tax: An Analysis

Emanating from the discussion of the tax maxims as outlined they may be interpreted in terms of the broader principles of social justice which demand that taxation should not only be equitable in the sense of impartiality but there should be elements of fairness. It is also evident from the discussion of the ability to pay and the equity of sacrifice that they are designed in such a way that reduces economic inequalities and has the ability to redistribute wealth (Rai, 2004:72; Chodorow, 2008:740). One of the very important subjects of taxation is the problem of incidence of a tax. The incidence of taxation refers to the final money burden of a tax or final resting place of a tax. It is the desire of every government, local government included that it should secure justice in taxation. It is only when government knows who pays tax that it can evolve an equitable tax system and it can easily tap important sources of taxation and ultimately collect large amount of money without adversely affecting economic and social life of the citizens of the country (Akintoye & Tashie, 2013:223).

This paper proceed to argue that a sound tax system should also promote equality or theoretical justice, which means that the tax burden should be proportionate to the taxpayer's ability to pay as was discussed in the theory of ability to pay (Rai, 2004:58). It is therefore on this viewpoint alluded that the other critical element of the sound tax system is the administrative feasibility, which means that tax laws must be capable of being convenient, just, and effective (Akintoye & Tashie, 2013:223). Tax possesses the power that can destroy and must be exercised with care in order to avoid or minimize the damage of the proprietary right of the taxpayer (Akintoye & Tashie, 2013:223). It can therefore be concluded that tax collection of municipalities in South Africa must maintain the general public's trust and confidence in the sense that it must be used justly and not deceitful. The power to impose rates and taxes by government which is in nature dependant of the power to legislate and implement cannot be delegated for obvious reasons. This limitation arises from the doctrine of separation of powers among the three branches of government and taxpayers are not relieved from the obligation of paying a tax because of the belief that it is being misappropriated by certain officials, for otherwise, collection of taxes would be hampered and this may results in the paralysation of important local government functions and service delivery.

In practice, the ability to pay theory asserts that there should be identification of non-payers and collect monies owed from those most likely to pay as this can also accelerate the tax recovery and collection and increase the revenue performance through the data driven decision making (Fjeldstad & Moore, 2009:5; Fjeldstad & Heggstad, 2012:23). The best practice segmentation in the tax collection function of municipalities includes an assessment of taxpayer's willingness and ability to pay the taxes, as well as values in monetary terms of what is at risk (SARS, 2010:50; Cattarelli, 2011:64; SARS, 2011:3; SARS, 2012:4; SARS, 2014:26-29). It can therefore be argued that in the current conjecture even those who have the capacity to pay rates and taxes are not paying hence the huge outstanding municipal debts that is found in South African municipalities.

5. A Close Look into South African Municipalities on Issues of Rates and Taxes

Tariff levels imposed by municipalities are not high to warrant complaints but yet the South African municipalities can only collect fifty percent of their target revenue per annum. This means that there is a need for the municipalities to strengthen their enforcement arm of revenue collection to ensure that those who are not paying are followed up and the outstanding rates and taxes are collected, even if this would mean enforcing payment using the hands of law as it is the case with SARS. It's however worth noting that based on the Cooperative Government and Traditional Affairs Department Report, and the press release on Local Government Revenue and Expenditure: Fourth Quarter Local Government Section 71 Report (Preliminary results) for the period 1 July 2014 – 30 June 2015, it is evident that there are challenges on the effectiveness of revenue collection.

On the issue of collection of debtor's book or debts, it is prevalent that the poor collection of the book is an issue of having or not having a clear and appropriate policy mechanism to recover debts. The key issue is the ability to recover debts or avoid the further escalation of the level of unpaid debts. In this regard it is important to consider what the various characteristics or salient features of the various categories of debtors. In this regard, various views prevail in that two main categories of debtors should be considered, with the first category being the underprivileged sector of the South

African population which makes out the majority. This category makes up a very significant part of the debtors book of municipalities, but falls completely out of the SARS net. The second category is the middle and affluent part of the community, as well as the business sector. This category falls squarely into the SARS and municipal nets. If the ability to recover tax is concerned, SARS only requires an execution strategy, as the various tax Acts provide ample powers of recovery. SARS only focus on the sphere of the community with the ability to pay or assets to attach in the case that non-payment. The collection function includes an assessment of taxpayer's willingness and ability to pay the taxes, as well as values in monetary terms of what is at risk (Cattarelli, 2011:64; SARS, 2011:3; SARS, 2012:4; SARS, 2014:26-29). It can therefore be argued that the ratepayers who are also taxpayers are more prone to pay SARS debt as compared to the municipalities, which can be attributed to the strength of SARS enforcement capabilities which is not there in municipalities.

It is evident that tax possesses the power that can destroy and should be exercised with care in order to avoid or minimize the damage of the proprietary right of the taxpayer (Akintoye & Tashie, 2013:223). It can further be argued that if the ability to pay theory is applied, then those citizens who do not have the means to pay for the services they will have to. In the meantime, these people will enjoy the benefit of the services that the municipalities provide if the benefit theory was to be applied. Tax collection must therefore maintain the general public's trust and confidence in the government particularly in municipalities as a constituent charged with the provision of providing basic services to communities.

6. Conclusion

This paper argued that the principles and theories of taxation that the basic principles of a sound tax system are based on fiscal adequacy. The sources of revenue in South African municipalities should be sufficient to meet the demands of public expenditure and financing service delivery. It also became evident from the paper that a sound tax system has the potency to also promote equality or theoretical justice, which means that the tax burden should be proportionate to the taxpayer's ability to pay as was discussed in the theory of ability to pay. There is no doubt that this could be linked to the ability of the have's and the have not's in the South

African context (Rai, 2004:58; Guj, Bacoum, Limerick & 2013:11). The ratepayers even if they have the ability to can pay rates and taxes and benefit from the municipal services, they are not committed to making the payment as they not prioritise the payment of rates and taxes. It can be concluded that ability to pay theory is applicable and applied in the South African context in the collection of rates and taxes while the who benefit is not applicable as those who are indigent will not have the financial resources to pay for such benefits.

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