CESifo Working Papers

10698
2023

October 2023

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CESifo

Impressum:

CESifo Working Papers
ISSN 2364-1428 (electronic version)
Publisher and distributor: Munich Society for the Promotion of Economic Research - CESifo GmbH
The international platform of Ludwigs-Maximilians University's Center for Economic Studies and the ifo Institute
Poschingerstr. 5, 81679 Munich, Germany
Telephone +49 (0)89 2180-2740, Telefax +49 (0)89 2180-17845, email office@cesifo.de
Editor: Clemens Fuest
https://www.cesifo.org/en/wp
An electronic version of the paper may be downloaded
· from the SSRN website: www.SSRN.com
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CESifo *Working Paper No. 10698*

Replacing Customs Revenue with Taxes on Income and Domestic Consumption: The South African Experience

Abstract

The African Continental Free Trade Agreement (AfCFTA) was signed by 54 member states of the African Union and is the largest free trade area in the world. Among other things, dismantling tariffs will have effects on public revenues in member states; this will require a revenue transition from customs duties to other forms of public revenues such as income and value added taxes. This transition may be a politically difficult process. This paper analyses the process of revenue transition in South Africa after World War I and after the end of the Apartheid regime to improve understanding of the constraints to and effects of such a revenue transition.
The transition in South Africa from a tax revenue structure anchored by customs revenue to one dominated by income taxes and taxes on domestic consumption was a protracted and unplanned process. The general revenue needs of the government led to the introduction of income taxes in 1914 and a broad-based consumption tax in 1979. In addition, excise taxes have been in use ever since the establishment of the Union of South Africa in 1910 and in recent times have become increasingly important for other purposes as well. Along with the shift in the role of customs duties from revenue-generating to protective instruments and fairly extensive use of non-tariff barriers, these developments meant that import taxes became markedly less important tax handles during the course of the 20th century. As a result, the revenue implications of the trade liberalisation process in the early 1990s were minor, and the implementation of AfCFTA would not be a large shock to government revenue in South Africa either.

JEL-Codes: H200, H270.

Keywords: free trade agreements, revenue transition, taxes, South Africa.

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This version: 4 October 2023

1 INTRODUCTION

The African Continental Free Trade Agreement (AfCFTA) was signed in March 2018 in Kigali by 44 of the 55 member states of the African Union. By March 2023, fully 54 member states had signed the agreement. The overriding general objective of the AfCFTA is to create a single market for goods and services, facilitated by the movement of people. By deepening the economic integration of the African continent, this would be an important step towards realising the Pan African Vision of "An integrated, prosperous and peaceful Africa" enshrined in Agenda 2063 (African Union, 2018: 4-5).

Many studies have been conducted assessing the potential welfare and trade implications of the comprehensive African integration plan (see, for example, Abrego, de Zamaróczy, Gursoy, Issoufou, Nicholls, Perez-Saiz and Rosas, 2020). However, the tax implications of the AfCFTA have not been explored in sufficient depth.[3] These implications include the effects that the scrapping of import tariffs on intra-African trade would have on government revenues and the scope for recouping such losses by generating more revenues from other taxes. The relatively low levels of government revenue in most African countries remain a constraint on the public provision of much-needed physical infrastructure and social services (UNECA, 2019). Hence, it would be essential to recoup losses of tariff revenue by introducing new taxes or by increasing the yields on existing ones. Such increases in tax burdens often provoke fierce resistance. Adverse fiscal effects therefore provide a possible explanation for sluggish implementation of free trade agreements (FTAs): governments may be concerned about the implications of trade liberalisation on tax revenues.

Various empirical techniques, such as computable general equilibrium modelling, could be used to analyse the government revenue effects of trade liberalisation. An alternative source of evidence is the historical experiences of countries. The reason why such experiences can be used for this purpose is that specific changes usually occur in the structure of countries' tax revenues during the process of economic development. Among the most prominent of these changes are increases in the revenue shares of incomes taxes and taxes on domestic consumption and a decrease in the revenue share of taxes on imports (Besley and Persson, 2014; 103-104). This paper draws on the historical experience of South Africa to comment on some economic and political aspects of the replacement of import taxes by income taxes and taxes on domestic consumption.

South Africa represents an interesting case study for the topic at hand because it was one of the first countries apart from today's advanced economies that significantly changed the structure of its tax revenues in this way. The catalytic event in this process was the introduction of a tax on personal and company incomes in 1914. An international comparison of 1959 figures clearly showed the effects of this and subsequent steps outlined elsewhere in paper: by then, South Africa's ratio of direct tax revenue (predominantly income taxes) to total central government revenue of 50 percent was the highest among 35 medium- and low-

[3] A few studies (e.g., Shinyekwa, Bulime and Nattabi, 2020) have explored such implications for regions in Africa.

income countries (Tun Wai, 1962: 431).[4] In fact, that ratio even exceeded those of ten of the 17 high income countries in the sample. In the same year, income from trade taxes (mainly import taxes) constituted 15 percent of South Africa's central government revenue (Tun Wai, 1962: 434). The corresponding ratios of 29 of the 33 other medium- and low-income countries and of three of the 13 high-income countries were higher than that of South Africa. When considering these figures, it should be kept in mind that central government revenue figures can be misleading for a group of countries with diverse levels of political decentralisation: inclusion of the revenues of state and local governments might have changed the tax structures of some countries markedly. Still, it could be said with some confidence that the tax structure changes discussed in this paper occurred relatively early in South Africa's process of economic development. The reasons for these changes, the sequencing thereof and the political economy of the process itself therefore may be of interest to other African countries intending to replace import taxes by income taxes or taxes on domestic consumption, whether in anticipation of the implementation of the AfCFTA or for other reasons.

The remainder of this paper is structured as follows. Section 2 provides a general perspective on the revenue transition necessary to compensate for the revenue losses associated with trade liberalisation in general and regional integration in particular. Against this background, Section 3 discusses key aspects of South Africa's revenue transition over the course of the twentieth century. Section 4 concludes the paper.

2 GENERAL PERSPECTIVES ON THE REVENUE TRANSITION

Relevant literature has identified various determinants of the government revenue effects of trade liberalisation and regional integration. This section outlines the following factors of this nature:

1. the distinction between industrialised and developed countries,
2. the motivation of trade policy,
3. the type of trade policy instruments to be dismantled,
4. the distinction between regional integration and unilateral/multilateral liberalisation,
5. the sequencing of the trade liberalisation process (the order in which trade barriers are removed), and
6. the sequencing of the trade and tax reforms.

First, it is important to distinguish between richer and poorer countries. Compared to poorer countries (such as African developing nations), richer countries normally impose higher tax burdens on their citizens. Besley and Persson (2014), among others, show that developing countries have systematically lower tax revenue-to-GDP ratios than industrialised countries. They explain such differences in revenue-to-GDP ratios in terms of aspects of countries' institutional settings such as levels of corruption, the strength and enforcement of private property rights, and the details of constraints on executive authority. Other factors that seem to contribute to such differences include the realities that poorer countries tend to have

[4] The figures quoted in this paragraph are taken from Table A.1 in the appendix.

higher levels of informal sector employment (International Labour Organisation, 2018) and less efficient tax administrations (Chang, Gavin, Gueorguiev and Honda, 2020). Gill (2003) offers a diagnostic toolkit for assessing the contours of revenue administration reform in developing countries. The distinctions that undergird this toolkit – those among inputs, the transformation process, and outputs – can be helpful to enhance tax reform processes.[5]

Cross-country differences in government revenues extend from overall tax burdens to their composition: thus, Besley and Persson (2014) also show that the share of trade taxes (i.e., tariff revenues), in total government revenue is markedly smaller in industrialised countries than in developing countries. An understanding of the reasons for these differences in the ability to raise tax revenues as well as the tax structure can also help to explain why developing countries may struggle to reduce their dependence on tariff revenues. Entrenched corruption, inadequate protection of private property rights, and the absence of accountable governance (as reflected in weak constraints on the executive branch) may well make it extremely difficult in political and economic terms to pursue trade reform and tax reform in a coordinated manner. These theoretical considerations are backed by empirical evidence. Baunsgaard and Keen (2010), for example, show that industrialised countries are more able than middle income or other developing countries to replace lost tariff revenues with income taxes or domestic consumption taxes such as value-added tax (VAT).

Empirical and case study evidence also underpins discussions about support by third countries or within free trade agreements (FTAs) of efforts to combine trade liberalisation and the revenue transition. Such external forces feature prominently in the vast literature on the political economy of trade liberalisation and tax reform (see, for example World Bank, 2022).[6] Walkenhorst's (2006) discussion of the option to compensate member countries of FTAs for tariff losses is another example.[7]

The motivation for tariffs and non-tariff barriers (NTBs) represents a **second** determinant of governments' ability to replace tariff revenues with taxes. Such motivations can have major consequences for the ability and political will to reform the public revenue regime (Ebrill, Stotsky and Gropp, 1999). Trade policy measures adopted for fiscal reasons and not to protect certain sectors or companies invariably take the form of tariffs, which are less distortive than NTBs in economic terms. If there is a realistic probability to introduce regular tax measures, governments may find strategies to replace the tariff if they are convinced of the positive welfare effects of trade liberalisation.

The incentives for governments to liberalise trade may be weak, however, if protectionist motives drive trade policy. Such governments will also have limited interest in reducing tariffs and finding new revenue sources; in fact, they might raise tariffs above the revenue

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[5] Ebrill, Stotsky and Gropp (2010: Box 2) discuss the most likely and successful path to the revenue transition against the background of these considerations.

[6] Vaubel (1991) uses the phrase "dirty-work hypothesis" to frame a discussion of the pros and cons of international support for politically costly domestic reforms.

[7] Such compensation is provided in the Southern African Customs Union (SACU) – the oldest customs union in the world.

maximising level. Alternatively, they may choose NTBs, which tend to more distortive and protective of vested interests than tariffs, without generating significant public revenues. However, as most trade policy measures today follow this protectionist logic and have moved from tariffs to NTBs, this argument may no longer be relevant – governments need tax policies to generate the revenues necessary to finance public spending programmes.

Third, it matters whether the trade liberalisation programme affects tariffs or NTBs, especially because tariff reductions have direct revenue implications whereas the dismantling of NTBs does not (Keen and Mansour, 2010). This implies that it makes sense from both the allocation and the revenue perspectives to reduce or dismantle NTBs such as border processes, red tape, regulations against foreign products, and the like. Apart from avoiding reductions in tariff revenues, such measures will increase welfare and may even secure higher tax revenues for governments in the longer run by raising the rate of economic growth. Dismantling of NTBs therefore increases tax revenues in absolute and relative terms. It should be added that reduced tariff rates may also increase tax revenues, as cheaper imports should bring welfare gains as well and eventually contribute to higher economic growth with similar benign revenue effects. In sum, the indirect fiscal effects of trade liberalisation are likely to be overwhelmingly positive, regardless of the instrument employed.

The impact of tariff reductions on government revenue is not limited to the indirect effects outlined above; there is also a direct impact that is ambiguous in nature. The net direct impact depends on the changes in the demand for import goods and the supply of domestic import substitutes. These changes hinge on price elasticities (Ebrill, Stotsky and Gropp, 1999):

- If import demand rises more than the price of the imported good decreases (i.e., if the price elasticity of demand is larger than 1), tariff revenues may rise.
- If the price elasticity is smaller than 1, tariff revenues would definitely decrease.
- Another aspect is the reaction of import competing industries, which – everything else equal – will lose. However, stronger competition may incentivise them to raise productivity through innovation and increasing X-efficiency. In such cases, imports as well as tariff revenues might fall irrespective of the price elasticity of demand.
- In addition to these considerations, Keen and Mansour (2010) point to the potentially complex responses in markets for imported intermediate goods to price reductions due to tariff reductions. This implies that cross-price elasticities are relevant as well. Such reactions may or may not lead to higher tariff revenues.

A **fourth** factor that is important for the fiscal implications of trade liberalisation is whether it occurs within a multilateral framework (where tariffs are not necessarily reduced to zero) or in the context of a regional integration project (where all tariffs between signatories of the FTA are normally abolished, as is envisaged to happen in the case of the AfCFTA). Trade in commodities is normally not subject to tariffs, as it is in the interest of any nation to buy resources as cheaply as possible. Tariffs usually increase as one moves up the value chain – a phenomenon known as tariff escalation. This implies that the reduction of tariffs on intra-African trade in manufactured goods to zero is likely to be challenging for governments.

To be sure, the situation would be different if countries belong to FTAs already and only have to reduce tariffs on imports from third parties. The transition from being heavily reliant on tariff revenues to mobilising tax revenue mainly from domestic economic activity may be easier then, as governments only have complete a process that had been started earlier by replacing the remaining tariff revenues with tax revenues. The policy reform process then becomes a more gradual one. Conversely, the scale and complexity of the revenue transition increase when a large reduction in the average level of tariff is required. In the context of the AfCFTA, it is therefore important that many African countries have already had to reduce their reliance on tariff revenues to become members of regional economic communities (RECs).

The sequencing of trade liberalisation measures is the **fifth** important issue – the most distortive measures should be abolished first, which may contribute to higher welfare and economic growth in a country as well as positive fiscal implications for the government. It was pointed out above that NTBs are generally more welfare distorting than most-favoured nation (MFN) tariffs. Consequently, governments that reduce distorting trade barriers first should find it easier to bring the transition process from tariff revenues to an ordinary tax regime with income taxes and taxes on domestic consumption as bases to fruition.

The **sixth** issue is whether trade liberalisation of tax reform should come first. Since both options have pros and cons from a political economy perspective, the answer to this question is not clear a priori. First consider the option of undertaking tax reform before trade reform. On the one hand, it may be much easier to liberalise trade if an income tax has already been introduced. The political cost of the revenue transition should be small once the electorate had agreed to the imposition of an income tax, because only a slight increase in income tax yields would be required to replace foregone tariff revenues – especially if the dynamic benefits of a significant trade liberalisation include a larger tax base. But on the other hand, a government that has become used to higher revenues after the introduction of an income tax may not see the necessity to embark upon trade liberalisation. This is likely especially if the main motive for trade policy measures is not a fiscal one, but the protection of certain well-organised sectors (Olson, 1965). Trade liberalisation will destroy the rents of such vested interests. This line of argument is somewhat questionable, however, as it rests on the assumption that political will to liberalise exists independent from the revenue situation.

Nest consider the alternative option: trade liberalisation before tax reform. In this case, too, it is not clear upfront whether a smooth revenue transition would occur. One possibility is that the liberalisation process may become irreversible once it has started. To maintain an adequate level of revenue, the government would then have no other option than to work out a proper tax regime. This would force the authorities to communicate with the taxpaying public and to seek a fair, efficient and effective tax regime. Such benign path dependence is not inevitable, though. Instead, the government may embark upon trade liberalisation in a half-hearted manner, partly to avoid or moderate its adverse revenue consequences. This would doom the entire liberalisation process to failure.

In sum, a significant number of factors influence the transition process from a tax system that depends mainly on tariff revenues to one dominated by income taxes and taxes on domestic consumption. Furthermore, these factors differ substantially across countries. Section 3 applies some of the theoretical and political economy considerations identified in this section to discuss the revenue transition in South Africa.

3 THE REVENUE TRANSITION IN SOUTH AFRICA

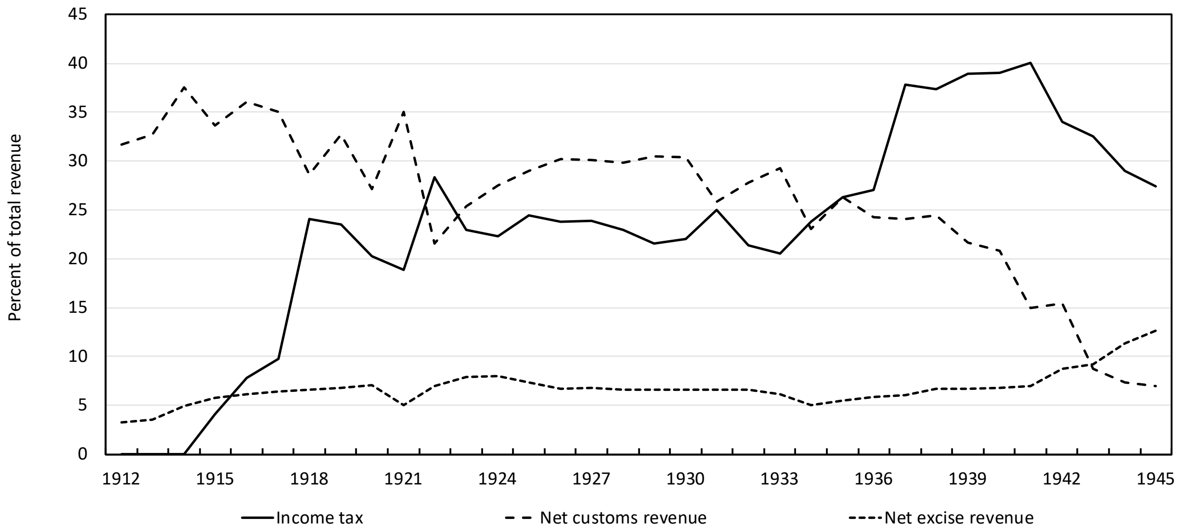
Section 2 emphasised the importance of the sequencing of government revenue transition processes. For this reason, it is useful to conceptualise the transition in South Africa as a process that had two stages. The first stage, which occurred in the period between the establishment of the Union of South Africa in 1910 and the end of the Second World War, was marked by a sharp drop in the government revenue share of customs duties, mainly because of the introduction of personal and corporate income taxes in 1914. During this period, the revenue generation function of customs duties fell in importance relative to their role as instruments to protect domestic industry against import competition. The second stage of the revenue transition began in the late 1970s with the introduction of a broad-based consumption tax in the form of the general sales tax (GST). The remaining decades of the 20th century brought a further decrease in the revenue share of customs duties with two roots: growth in the shares of income taxes and two types of domestic consumption taxes (excise duties and broad-based consumption taxes) as well as trade liberalisation in the early 1990s. This section discusses these two stages in more detail and outlines their effects on the tax structure in South Africa.

3.1 The first stage

Figures 1 and 2 summarise trends in the revenue importance of selected taxes in South Africa from 1912 to 1945 (the Union of South Africa came into being in 1910, but corresponding figures for that year and 1911 are not available). Whereas Figure 1 depicts shares of total central government revenue[8], Figure 2 shows ratios of GDP (GDP estimates for the years before 1918 are not available). As was stated earlier, import taxes were major tax handles in the early years of the Union of South Africa: the total revenue share of net customs duties amounted to 31.7% in 1912. In the same year, net excise duties contributed 2.3% of central government revenue. The composition of government revenue then changed markedly after the introduction of income taxes (that is, taxes on personal incomes and company profits) in 1914. By 1945, income taxes accounted for 27.4% of total central government revenue, and had become the single biggest source of tax revenue for the Union Government. A separate tax on the profits of mines then contributed an additional 18.4% of central government revenue. In contrast, the revenue share of customs duties had shrunk to 7.0% by 1945. Excise taxes, which amounted to 12.6% of total central government revenue, by then had also surpassed customs duties in importance as a source of government income.

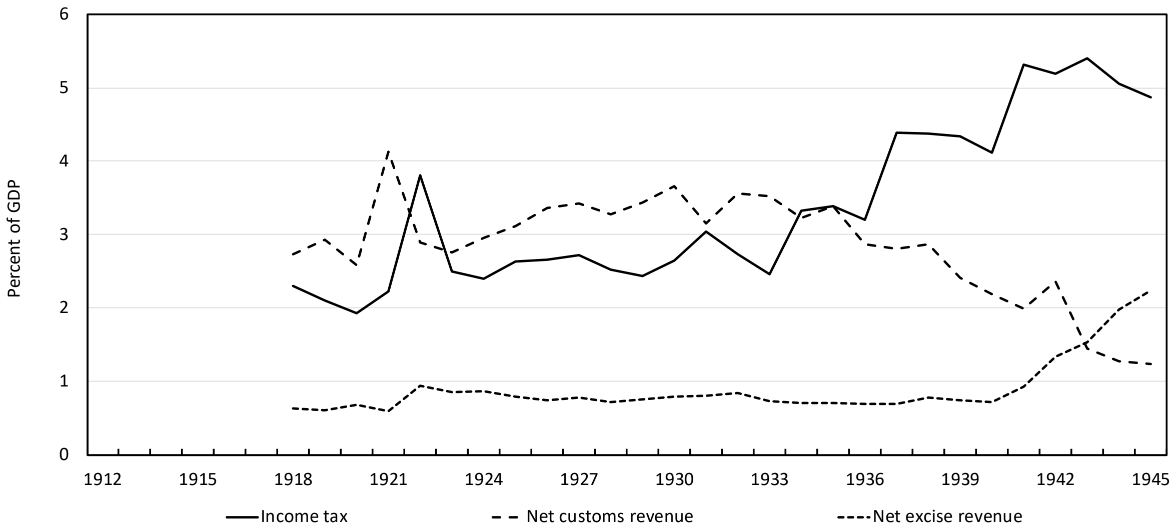
[8] These consist of all revenues mobilised by the Union (or central) government, that is tax as well as non-tax revenue (e.g., mining licences and income from the provision of rail services).

Figure 1: Government revenue shares of selected taxes in South Africa (1912-1945)



Source : Bureau of Census and Statistics (1960).

Figure 2: GDP shares of selected taxes in South Africa (1912-1945)



Source : Bureau of Census and Statistics (1960).

The newly introduced income tax was levied on all persons and non-mining companies with taxable incomes in excess of ₤1 000 per annum.[9] However, dividends and debenture interest earned from companies liable for income tax or mining tax were exempt in the hands of persons. The income tax had a progressive structure with a top marginal rate of 1s 6d per ₤ on taxable incomes exceeding ₤24 000 (see De Kock, 1924: 231).

By 1915, most of today's high-income countries had income tax systems in place or had experimented with such taxes (Aidt and Jensen, 2009: 162). In several of them, however, this was a protracted and politically fraught process (see, for example, Grossfeld and Bryce, 1993).

[9] It was stated above that mining companies were liable for a separate tax on their profits (see De Kock, 1924: 256-265). Whereas the tax rate for gold and diamond mining companies was 10%, that for all other mining companies started at 2.5% and then increased in line with the ratio between profits and gross revenue.

Hence, it is pertinent to ask why South Africa adopted the income tax at such a relatively early stage and whether it was as complicated a process as in some other countries.

With regards to the first question, De Kock (1924: 233) and Hattingh (2016: 56-62) state that the main reasons for the introduction of the income tax were the revenue needs of the Union Government amidst difficult economic conditions (especially in the then crucial agricultural sector) and sustained growth in public spending. Although it was not adopted specifically to reduce the fiscal authorities' reliance on customs duties, the income tax was intended to compensate for revenue losses associated with the creation of the Union of South Africa: various taxes levied by minorities of the four former colonies as well as the customs and railway tariffs on inter-colonial trade fell away in 1910 (more details on these developments are provided below) Hattingh (2016: 56) also points out that the costs associated with the Union's participation in the First World War was not a consideration when the income tax was introduced. That step preceded the eruption of the war; furthermore, at that stage it was not even clear whether the Union would fight alongside Great Britain on foreign soil.

The second question is particularly interesting in view of the reality that the adoption of the income tax elicited less political resistance in South Africa than in some other countries. There were a number of possible reasons for this. One may have been that Jan Smuts, the Minister of Finance at the time, skillfully managed the legislative process to overcome resistance to the income tax from opposition parties and some members of his own South African Party. He prepared extremely well for the debates about the tax, carefully chose arguments related to the economic situation and the fairness properties of a progressive income tax to mobilise support, and used agenda-setting powers to advance the progress of draft legislation. It should also be noted that income taxes were not unknown in South Africa at the time: The Cape Colony and the Natal Colony had introduced embryonic income tax systems in the first decade of the 20th century, while the South African Republic had taxed the profits of its lucrative gold mining sector in the closing years of the 19th century (De Kock, 1924: 233, 256). Another factor may have been that personal income tax at first affected a very small portion of the Union's population. The income tax threshold initially was set at a relatively high level of ₤1 000 – the corresponding threshold in England at the time was ₤350 – to reduce the risk of a taxpayer revolt, especially in the former Boer Republic where personal incomes had not been taxed before (Hattingh, 2016: 66-67). Thus, only 5 542 individuals and 615 companies were assessed for tax purposes in 1915 (Bureau of Census and Statistics, 1960).[10]

Political developments in the first decade of the 20th century had important implications for the role of customs duties in the South African tax system. The South African War – which was fought between Great Britain (supported by two coastal colonies: the Cape Colony and

[10] In all likelihood, this argument applied only in the first few years of the existence of the income tax: the threshold was reduced significantly, marginal rates were increased and a super tax on very high incomes and profits was introduced as the First World War compounded the pressure on the public finances. Thus, the number of individuals assessed grew to 109,162 in 1921 and 294,58 in 1945, while the corresponding figures for companies were 2,540 and 5,008, respectively (Bureau of Census and Statistics, 1960). Income tax receipts kept increasing in subsequent years because of regular reforms to aspects of the tax as well as growth in personal incomes and company profits.

the Natal Colony) and two inland Boer states (the South African Republic, also known as the Transvaal, and the Republic of the Orange Free State) – ended in 1902. Britain subsequently governed much of modern-day Southern Africa as four colonies (the Cape Colony, Natal, the Orange Free State and the Transvaal) and five protectorates (Barotseland, Basutoland, Bechuanaland, Southern Rhodesia and Swaziland).[11] When the South African Customs Union (SACU) was established 1903, the rail tariffs and customs duties on trade between these territories were abolished (Maasdorp, 1990:14-15).[12] At the same time, a common external tariff in the form of a 10% ad valorem duty was introduced to serve the twin purposes of revenue generation and protection of domestic industry (De Kock, 1924: 202). The Union of South Africa was established in 1910 by the amalgamation of the four British colonies. One of the consequences of this development was the replacement of the customs area agreement of 1903 by the Southern African Customs Union, which consisted of the Union and the so-called "High Commission Territories" (Basutoland, Bechuanaland and Swaziland). The new SACU agreement provided for the distribution of customs revenues between the four territories on the basis of their shares of the total customs and excise revenues in the three years before it came into effect (Maasdorp, 1990: 15).

The Customs Tariff Act of 1914 provided for a mixture of specific and ad valorem duties that served the twin purposes of generating government revenue and protecting domestic industry. In addition, the customs duties system incorporated Imperial preference, that is, preferential treatment of Great Britain and reciprocating British Dominions (Australia, Canada and New Zealand). The drop in the revenue share of customs duties over the entire period from 1912 to 1945 (see Figure 1) did not reflect wide-ranging trade liberalisation or general reductions in the levels of tariffs; in fact, Figures 1 and 2 show that the revenue and GDP shares of customs duties were relatively stable in the interwar period. It follows that income tax revenue augmented rather than substituted for import taxes. As was suggested earlier, however, the role of customs duties changed from that of an instrument used primarily for revenue generation to incorporate the goal of stimulating diversified industrial development by protecting domestic firms (De Kock, 1924: 205-206). Following debates in the legislature and research by the Board of Trade and Tariffs, a new Customs Tariff Act was passed in 1925. According to Fallon and Preira de Silva (1994: 73), this marked the initiation of an "inward-looking industrialisation path" centered on protection of the manufacturing sector. The policy of protection was based on various considerations, including the desire to support industries established during the First World War, the need for industrial job creation to address growing problem of urbanising "poor whites" displaced from farms by a series of droughts and other factors, the realisation that diversification away from a heavy reliance on gold mining at some point would become essential, and a new spirit of economic nationalism (Botha, 1973: 334). Although the research of the Board of Trade and Tariffs showed that policymakers were well aware of the government revenue potential of expanding the system of import tariffs, this seemingly was a secondary consideration. The reality that the tariffs were complemented by

[11] The former protectorates are now known as Zambia, Lesotho, Botswana, Zimbabwe and Eswatini, respectively.

[12] Swaziland joined the SACU in 1904 and Barotseland in 1905.

an extensive system of quantitative restrictions (QRs) on imports confirmed that the new trade policy was focused mainly on protection (Belli, Finger and Ballivian, 1993: 2).

De Kock (1924: 203) points out that it was difficult in practice to reconcile the goals of generating government revenue, protecting domestic industry, and maintaining trade preferences with Great Britain and reciprocating British Dominions (Australia, Canada, and New Zealand): "[I]t frequently happened that the interest of revenue, protection and Imperial preference did not coincide, and this clash of interests led to a great deal of patchwork and the creation of a tariff which contained many anomalies". Nonetheless, he shows that the tariff rates and, by implication, levels of protection were modest compared to those in Australia, Canada, New Zealand and the United States (De Kock, 1924: 216-217; see also Belli et al., 1993: 2).

Excise taxes had been used extensively in South Africa since early colonial times, mainly as a revenue-raising tool. The taxes levied on modern-day "sin goods" (spirits, beer and cigarettes) were standardised after the establishment of the Union of South Africa (De Kock, 1924: 108). According to De Kock (1924: 110), the Government's revenue needs during the First World War motivated increases in the rates of existing excise taxes as well as the introduction of new duties on goods ranging from tea, coffee and sugar to boots and shoes. These steps caused the increases in the revenue and GDP shares of excise taxes shown in Figures 1 and 2.

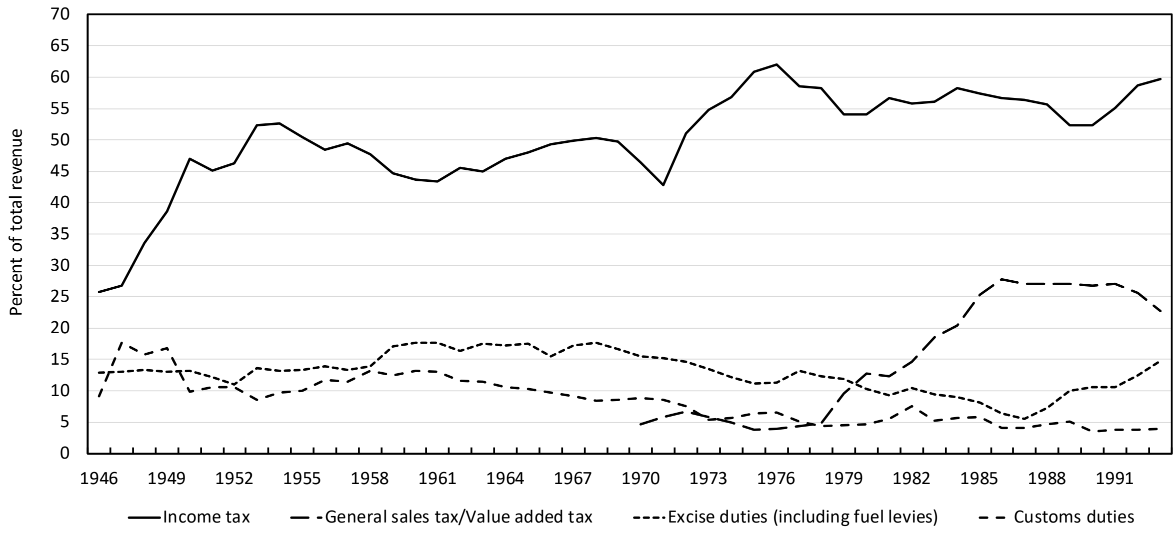
3.2 The second stage

The changes in the revenue and GDP shares of selected taxes in depicted in Figures 3, 4, 5 and 6 form the backdrop for the following discussion of the second stage of the revenue transition in South Africa.[13] As was pointed out earlier, the upward trend in the revenue share of income taxes continued in the second half of the 20th century; in fact, it more than doubled from 25.8% in 1946 to 59.8% in 1993. The first report of the Franzsen Commission (1969: 3) states that this reflected the “large but relatively stagnant contribution of companies, the modest but rapidly growing contribution of the personal income tax, the decreasing share of customs duties and the limited potential of the current excise duties”.[14] The major role of the mining sector in the South African economy was the main reason for the high government revenue share of company tax (Krogh, 1969: 298). The small tax base – a function of the extremely unequal income distribution of income – has long restricted personal income tax mobilisation in South Africa. However, sustained growth in personal incomes during the early decades of the second stage of the revenue transition coupled with failure on the part of the fiscal authorities to fully offset the effects of inflation on taxable incomes from the early 1970s onwards (Abedian and Biggs, 1995) contributed to marked growth in the government revenue

[13] These figures are not fully compatible with the ones in Figures 1 and 2. Hence, the various series were not consolidated to show trends in the full period from 1912 to 1993.

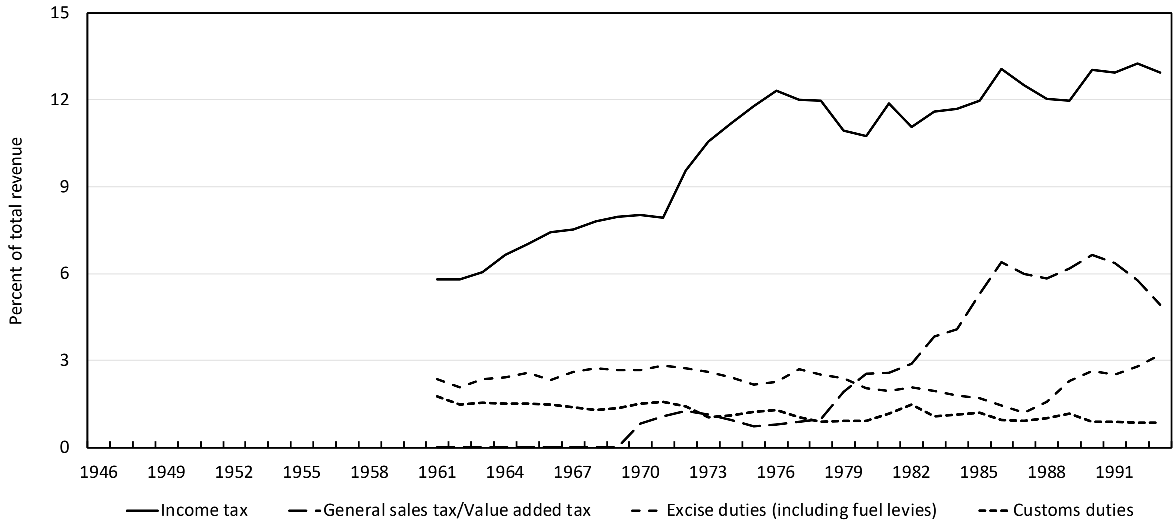
[14] A consistent series of the contributions of personal income tax and corporate tax to total income tax receipts is available only for the years from 1981 onwards (see South African Reserve Bank, 1994: B.131-B.134). In that year, these contributions amounted to 15.4% and 38.7%, respectively. Although affected by the exceptional profitability of gold mines in the wake of the sharp spike in the gold price in 1980s, these proportions were not drastically different from those in other years.

Figure 3: Government revenue shares of selected taxes in South Africa (1946-1993)



Source : South African Reserve Bank (1994).

Figure 4: GDP shares of selected taxes in South Africa (1946-1993)



Source : South African Reserve Bank (1994).

share of personal income tax. From 1981 to 1993, for example, that share increased from 15.4% to 39.0%, while the share of company tax collections shrunk from 38.7% to 15.6% (South African Reserve Bank, 1994: B.131-B.134). Some would argue that the buoyancy of the income tax system from the mid-1980s onwards also reflected the acceptance by fiscal policymakers of the efficiency-based case for broadening tax bases while reducing the company tax rate as well as marginal tax rates on personal incomes (Steenekamp and Döckel, 1993: 320-326).

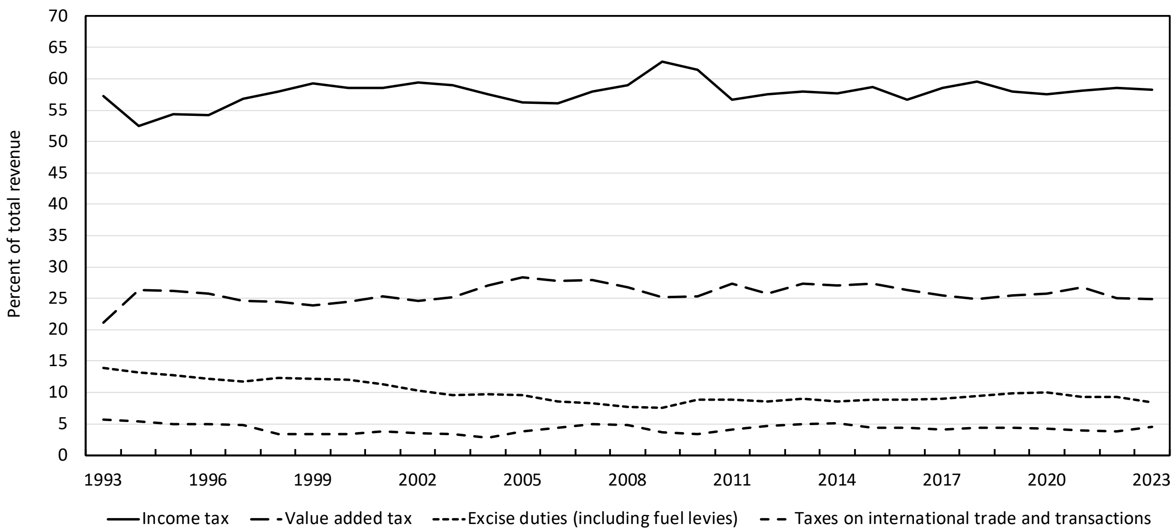
The adoption of a broad-based tax on domestic consumption in the form of the general sales tax (GST) of 4% in 1979 was an important step in the further diversification of the government revenue base in South Africa. In part because its rate was raised steadily to reach 13% in 1989, the GST soon became a major source of government revenue (see Figure 3). Its effect on the revenue share of all domestic consumption taxes other than excise duties was immediate, and the growth in that share from 4.8% in 1978 to 27.0% in 1991 made it a much more productive revenue source for the South African fiscal authorities than customs and excise duties. The GST was replaced by a comprehensive Value Added Tax (VAT) in 1991. The VAT was introduced at a rate of 10%, coupled with rates of zero of a small number of basic foodstuffs that feature prominently in the consumption baskets of poor households. In conjunction with the recessionary conditions at the time, these rates characteristics of the VAT caused the initial drops in the revenue and GDP shares depicted in Figure 3 and 4. The VAT rate was increased to 14% in 1993. It has been described as a well-designed tax that has yielded much revenue while having only a modest regressive effect because of the zero-rating of certain basic foodstuffs (see, for example, Go, Kearney, Robinson and Thierfelder, 2005).

It is clear from Figures 3 and 4 that the revenue share of excise taxes fluctuated between 1946 and 1993, but decreased for much of this period. It also decreased as a ratio of GDP between 1961 and 1993. Drawing on an analysis by the then Department of Finance (now National Treasury), Steenekamp and Döckel (1993: 329) state that excise taxes were not raised in line with inflation from the late 1970s onwards. Although their revenue-raising function remained important, the role of these taxes increasingly shifted to that of discouraging consumption of so-called "sin goods" with negative external effects such as alcoholic beverages and tobacco products. A levy on fuel sales was introduced in 1988 to finance road maintenance and construction. The proceeds of this tax soon became part of the general revenue pool, though.

As a counterpart to these trends, the revenue and GDP shares of customs duties remained modest during this period. In fact, both ratios dropped further, and by 1990 customs duties amounted to only 3.5% of total government revenue and 0.9% of GDP. They remained vital for trade policy purposes, though. Augmented by quantitative restrictions, import tariffs contributed to the growth and diversification of the South African manufacturing sector in the 1950s and 1960s (McCarthy, 1999: 143-144). While this process made South Africa largely self-sufficient in the production of basic consumer goods, the manufacturing sector itself and the rest of the economy remained highly dependent on imported capital and some intermediate goods. The results were high levels of concentration and, indeed, inefficiency in key sectors of the economy. With the passage of time, this process of deliberate import substitution was reinforced by sanctions against the apartheid regime, an increasingly binding balance of payments constraint that necessitated the imposition of import surcharges, and effective lobbying by domestic manufacturers (Edwards, 2005: 755). Belli, Finger and Ballivian (1993: 7) reported that South Africa's average tariff was modest by international standards circa 1990, but added that the tariff schedule as a whole had become extremely complicated: their comparison of 32 developing countries showed that South Africa had the most tariff rates, the widest range of tariffs, and the second highest coefficient of variation of the tariff rates. By then, the deterioration in the performance of the manufacturing industry that had started in the 1970s had become a matter of much concern (see Black and Stanwix, 2008).

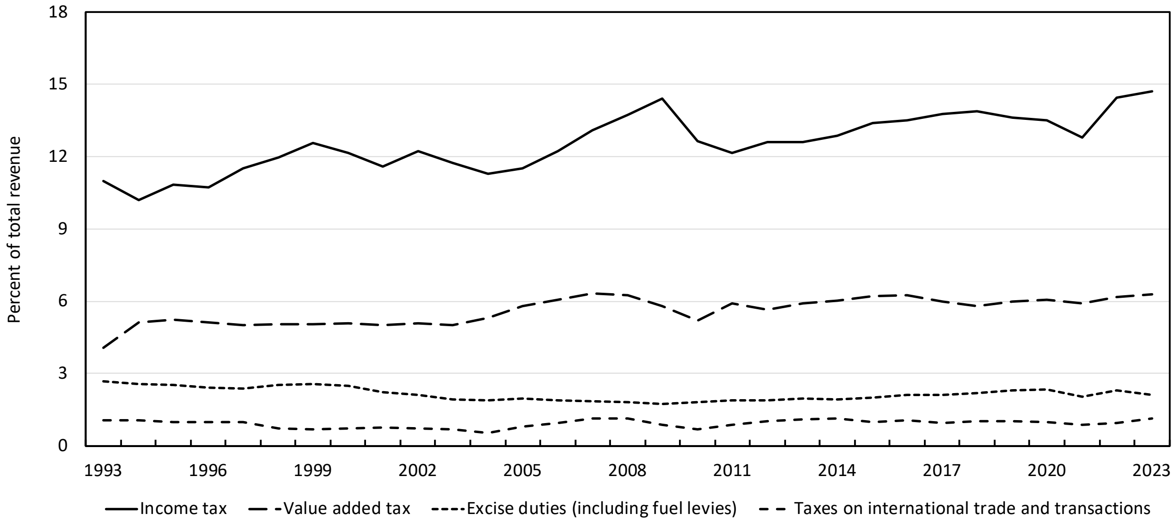
According to Edwards (2005: 755), a gradual shift away from import substitution began in South Africa in the 1970s with the partial dismantling of quantitative restrictions on trade and the introduction of limited export incentives. Further steps of the same nature occurred in the early 1990s. In 1993, South Africa made a wide-ranging trade liberalisation offer to the World Trade Organisation (WTO) as part of the country's accession process. The Government committed itself to bind fully 98% of all tariff lines, reduce the many tariff rates to six, rationalise the more than 12 000 tariff lines, replace quotas on agricultural products with tariffs, and phase out the General Export Incentive Scheme (GEIS), which clashed with the rules of the WTO (Edwards, 2005: 755). The actual implementation of this offer gave rise to a lively debate between economists who believed that significant trade liberalisation occurred (e.g., Roberts, 2000) and those who took the opposite view (e.g., Fedderke and Vaze, 2001). Having analysed a newly assembled tariff dataset, Edwards (2005: 755) concluded that "significant progress has been made in simplifying the tariff schedules and reducing tariff protection, but further progress can be made in removing tariff peaks, reducing tariff dispersion, and lowering the anti-export bias arising from protection". He added, however, that the relaxation of protection in South Africa had not been faster than in peer countries.

Figure 5: Government revenue shares of selected taxes in South Africa (1993-2023)



Source : South African Reserve Bank (2023).

Figure 6: GDP shares of selected taxes in South Africa (1993-2023)



Source : South African Reserve Bank (2023).

South Africa's trade liberalisation effort has attracted some academic criticism (e.g., Bond, 2000: 48-49), but caused little overt political opposition. Although it was linked to South Africa's WTO accession process, the "dirty-work hypothesis" probably did not apply in the sense that the government never used this as an excuse to defuse opposition to trade liberalisation. While a fuller discussion of the debates about the scope of South Africa trade liberalisation effort[15] and its economic implications falls outside the scope of this paper, it is notable that neither total revenue nor revenue from taxes on international trade and on total tax revenue was adversely affected. On the contrary, national government revenue rose from 19.4% of GDP in 1994 to 25.3% in 2023. Over the same period, revenue from taxes on international trade and transactions fell from 5.4% to 4.5% of national government revenue, but increased marginally from 1.0% to 1.1% of GDP (see Figures 5 and 6). It is also evident that South Africa's dependence on revenues from income taxes has increased further since 1994. However, the fluctuations in revenues from income taxes and taxes on domestic consumption depicted in Figures 5 and 6 reflected broader economic developments rather than deliberate attempts to change the tax structure.

4 CONCLUSION

The transition in South Africa from a tax revenue structure anchored by customs revenue to one dominated by income taxes and taxes on domestic consumption was a protracted and unplanned process. The general revenue needs of the government led to the introduction of income taxes in 1914 and a broad-based consumption tax in 1979. In addition, excise taxes have been in use ever since the establishment of the Union of South Africa in 1910 and in recent times have become increasingly important for other purposes as well. Along with the shift in the role of customs duties from revenue-generating to protective instruments and fairly extensive use of NTBs, these developments meant that import taxes became markedly less important tax handles during the course of the 20th century. As a result, the revenue implications of the trade liberalisation process in the early 1990s were minor, and the implementation of AfCFTA would not be a large shock to government revenue in South Africa either.

Other African countries will not be able to spread the revenue transition over such a long period as South Africa did. Moreover, various aspects of country's tumultuous history during the 20th century shaped the details of the process. Still, South Africa's revenue transition confirmed that appropriate diversification of the tax base and sequencing of changes to the tax structure can nullify the potentially disruptive effects of enforced changes such as those associated with economic integration.

[15] For a discussion of this debate and the measurement issues that stoked it, see Holden (2005).

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Appendix Table A.1: Aspects of the structure of government revenue in 52 countries (1959)

Central government revenue (percent of national income)		Direct tax revenue (percent of central government revenue)		Trade tax revenue (percent of Central government revenue)	
Austria	32.9	United States	80	Ghana	63
New Zealand	31.4	Venezuela	63	Haiti	60
United Kingdom	30.8	Netherlands	61	Costa Rica	59
Finland	29.6	Australia	59	Ceylon	55
Venezuela	27.1	Canada	56	Malaya	53
Israel	26.6	New Zealand	51	Honduras	49
Ireland	26.1	United Kingdom	51	Guatemala	43
Netherlands	25.8	*South Africa*	*50*	Ecuador	40
France	25.4	Sweden	49	El Salvador	37
Norway	25.0	Japan	47	India	36
Australia	24.0	Denmark	43	Lebanon	35
United Arab Republic	23.7	Colombia	42	Sudan	35
Germany	23.2	Belgium	40	Colombia	34
Sweden	22.9	Spain	40	Panama	33
Italy	22.7	Israel	35	Indonesia	30
Ceylon	22.4	Mexico	35	Switzerland	30
Chile	21.9	Brail	34	Thailand	30
Greece	20.9	Austria	33	Greece	29
Burma	20.6	Syrian Arab Republic	33	Burma	28
Denmark	20.6	Chile	32	Korea	28
Iraq	19.8	Portugal	31	Israel	25
Peru	19.3	France	29	Philippines	25
South Africa	*18.8*	Norway	27	Iran	24
Malaya	18.7	Switzerland	27	Pakistan	24
Belgium	17.7	Turkey	27	Mexico	23
Canada	17.6	Ireland	26	Portugal	23
United States	17.1	Burma	25	Iraq	22
Korea	16.7	Panama	25	Italy	22
Costa Rica	16.2	Pakistan	24	Venezuela	22
Syrian Arab Republic	16.1	Argentina	23	Chile	20
Guatemala	15.9	Finland	23	Peru	18
Portugal	15.7	Peru	23	Syrian Arab Republic	18
Panama	14.8	Italy	22	Brazil	15
Lebanon	14.7	Korea	22	*South Africa*	*15*
Ghana	13.9	Honduras	21	New Zealand	14
Ecuador	13.7	Thailand	21	Finland	13
El Salvador	13.6	Ceylon	20	Turkey	12
Spain	13.2	Germany	20	Canada	10
Japan	12.9	Greece	20	Netherlands	9
Thailand	12.9	United Arab Republic	20	Spain	8
Honduras	12.1	Indonesia	18	Austria	7
Pakistan	11.6	Lebanon	18	Norway	7
Argentina	11.1	Costa Rica	17	Australia	6
Philippines	10.5	India	17	Japan	6
Indonesia	10.4	Ecuador	16	Argentina	5
Brazil	10.1	Malaya	15	Sweden	5
Haiti	9.9	Philippines	13	Belgium	4

Turkey	9.9	El Salvador	12	United States	2
Colombia	8.3	Iraq	10		
Mexico	8.1	Ghana	10		
Switzerland	8.1	Haiti	8		
India	7.7	Guatemala	7		

Source: Tun Wai (1962: 429, 41, 434)