

Southern Africa – Towards Inclusive Economic Development

Evaluating the impact of South Africa's 2017 top marginal tax rate reform

In 2017, South Africa introduced a tax reform that increased the top marginal tax rate from 41% to 45% for incomes over ZAR 1.5 million. This reform was designed to target the top 0.6% of income earners with two clear goals: **increasing government revenue** and **reducing after-tax income inequality**.

In a recent SA-TIED working paper, researchers show that the reform triggered sizable behavioral responses among high-income earners, who significantly lowered their reported taxable income. In consequence, the expected revenue gains did not materialize, prompting the researchers to dig more deeply into the economic and behavioural factors behind this outcome.

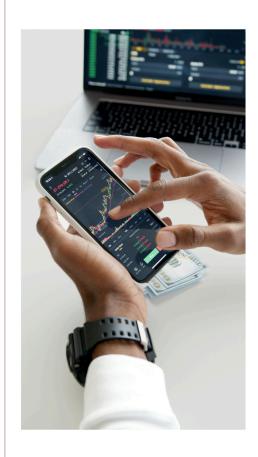
The behavioural response of high-income earners

The findings suggest that responses were centered around adaptable forms of compensation that are more flexible and easier to adjust in response to tax changes. Non-monetary compensation, such as fringe benefits, stock options, and allowances, can be subject to tax in South Africa depending on how they are structured. For example, employees may be taxed on the value of a company car or when exercising stock options. Following the reform, there was a 7.88% decrease in reported taxable income from high earners, primarily driven by reductions in bonuses, incentive payments, and fringe benefits. The research found that non-monetary compensation and performance-based pay saw the most significant declines, possibly because high-income earners and their employers adjusted pay structures to minimize the tax burden. Annual bonuses and incentive payments, which make up a substantial portion of total compensation for top earners, were also reduced.

Regular monthly labour income, which is more rigid and directly reported to tax authorities, remained largely unchanged. This may indicate that high-income earners focused their tax reduction efforts on more flexible components of their compensation. Given that the data is reported by a third party, it is also possible that both employees and employers collaborated to optimize compensation structures, highlighting the flexibility that high earners can leverage within the tax system

High-income earners, particularly those with flexible compensation, reduced their taxable income following the reform. The share of after-tax income among the top 0.6% fell from 11.54% to 10.58%.

- The reform led to a ZAR 6.48 billion revenue shortfall.
- Sales in firms employing workers affected by the reform declined by around 4%, possibly reflecting real economic consequences of the tax change.



Economic impact on firms

The tax reform also had repercussions beyond individual responses, affecting firms employing high-income earners. Research using administrative tax data revealed a moderate decline in firm output, suggesting that reduced incentives for top earners might have broader economic implications. Specifically, the sales of affected firms dropped by around 4% on average.

This suggests that the tax increase could have demotivated employees from achieving performance targets, particularly when bonuses and other forms of incentives were cut. This is consistent with performance-based compensation being key to driving productivity and efficiency within firms.

Measuring the impact and isolating the reform's effects

To accurately assess the tax reform's impact, researchers employed a difference-in-differences style approach to isolate the specific effects of the reform from other factors that could have influenced income levels, such as broader economic changes, inflation, or investment trends. By controlling for these external factors, the study ensured that its findings reflected the direct consequences of the tax reform on high-income earners' responses and the resulting economic effects.

Was the drop in incomes really due to the reform?

A key challenge in understanding the reform's impact lies in determining whether the drop in reported income was solely the result of the tax policy or if other external factors were at play. Given the complex economic context during the period, some have argued that income levels may have been influenced by external conditions, such as global market volatility or changes in domestic investment. However, the methodology used in the study indicates that the observed decline in reported incomes was a direct result of the tax policy by comparing income levels before and after the reform and controlling for other determinants.

Conclusion

The 2017 top marginal tax rate reform in South Africa provides valuable lessons for policymakers, both domestically and internationally. While the reform did succeed in achieving a mild reduction in after-tax income inequality, it failed to deliver the expected revenue gains. Furthermore, the negative impact on firm output highlights the unintended economic consequences that can arise from tax policies targeting high-income earners.

These findings underscore the importance of designing tax policies that balance equity and economic stability, particularly when dealing with top earners who have the flexibility to adjust their income reporting in response to tax changes.

This Research Brief is based on WIDER Working Paper 37/2024 'Taxing top incomes in the emerging world: Economic impact under the microscope', by Christopher Axelson, Antonia Homann, Jukka Pirttilä, Roxanne Rabbe and Nadine Riedel.

IMPLICATIONS

- Increased marginal tax rates may not always lead to anticipated revenue gains, as high-income earners adjust their behaviour in response to tax charges.
- The observed decline in firm productivity, demonstrates the importance of designing tax policies that balance the objectives of equitable taxation and economic growth.
- Future tax reforms should account for the behavioural responses of top earners and focus on closing tax loopholes to ensure a fair and effective tax system.









