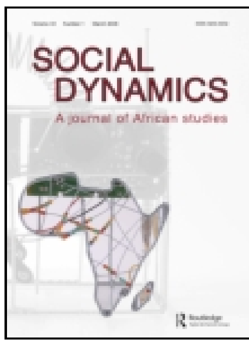

Social Dynamics

ISSN: 0253-3952 (Print) 1940-7874 (Online) Journal homepage: https://www.tandfonline.com/loi/rsdy20

Financing a universal income grant in South Africa

Pieter le Roux

To cite this article: Pieter le Roux (2002) Financing a universal income grant in South Africa, Social Dynamics, 28:2, 98-121, DOI: 10.1080/02533950208458734

To link to this article: https://doi.org/10.1080/02533950208458734

Published online: 13 May 2008.

Submit your article to this journal

Article views: 337

View related articles

Citing articles: 2 View citing articles

Full Terms & Conditions of access and use can be found at
https://www.tandfonline.com/action/journalInformation?journalCode=rsdy20

Social Dynamics 28:2 (2002): 98-121

Financing a Universal Income Grant in South Africa

Pieter le Roux[1]

Abstract

A universal income grant can be financed through an increase in indirect taxes. The actual or net burden is less than one third of the gross cost of the payments made, i.e. about R15 billion rather than R52 billion. The net impact remains progressive, with the affluent progressively paying more and the poor progressively benefiting more. Financing a universal grant through what is effectively an expenditure tax increase is far less likely to distort the economy than increases in income taxes or company taxes. The proposal also avoids the problem of poverty traps. Paying the grant to individuals (except for children, whose grants are paid to the care-giver) and making the net benefit or burden of the proposed grant dependent on individual expenditure rather than on family or household income, means that largest benefits are targeted on those household members (typically women and children) who receive small proportions of family income. Recent technological developments mean that it might soon be possible to implement the system here proposed.

Introduction

In its report, *Transforming the Present, Protecting the Future,* released in March 2002, the Committee of Inquiry into a Comprehensive System of Social Security for South Africa made the recommendation that a universal income grant of R100 should be phased in during the next three to four years. The Committee provided an overall financial framework to show that this, and its other equally crucial recommendations concerning in particular the health and pension systems, would be feasible given the goals government has set for itself (South Africa, 2002: Chapter 14; for a critique, see Barberton, 2002). But, although it had studies done of the specific financial implications of a universal income grant and referred to the results of these studies in passing, the Committee respected the view of the Treasury that the details of how to

finance such a grant were outside its brief and should be left to the Treasury (South Africa, 2002: 134).

As the member of the Committee responsible for one of the reports estimating the additional burden that such a grant will impose[2], I regret that we took this decision. For the reality is that one cannot decide whether one is for or against an income grant without knowing (1) what is the additional tax burden imposed on the South African economy and (2) whether the net effect of grant and tax increases is well targeted to benefit those who are destitute.

If the grant is financed in a fashion that enables everyone, regardless of how affluent they may be, to get the full benefit of the grant (in other words, if the grant is *not recouped* from the high income groups by increases in their taxes), and if one accepts the cost estimates of delivery of the grant made by Treasury, a universal income grant would in year 2000-2001 have increased our tax burden by about R60 billion a year – an amount larger than the entire education budget and clearly a very hefty bill indeed. Such cost estimates, based on work done by economists such as Van der Berg (2002) and Bhorat (2002), are being used in the debates within the African National Congress (ANC), and between the ANC and its partners. It is no wonder that even some people who favour a universal grant in principle have decided not to go this route.

If, however, one looks at the cost of paying out the grant only to those not yet entitled to any other grant, if one ignores for the time being the delivery costs of the grant, and if one recoups the grant from those who are more affluent through increases in indirect taxes (such as the fuel tax, excise levies and value added tax [VAT]), then the *net* additional burden imposed on the tax payers by the grant itself will be only about a quarter of this amount, or about R15 billion per year. If the cost of delivery can be kept low, then a universal income grant is clearly more affordable.

What is more, as I will show in this paper, a grant thus financed will in effect be targeted to give most help to those most in need, without creating the poverty traps so common to means-tested grants. The net impact of a universal grant combined with an increase in indirect taxes has the same effect on citizens with monthly expenditure below about R1080 as an anti-poverty grant which increases by about 9% for every Rand monthly expenditure is *below* R1080, and the same effect on citizens with monthly expenditure above R1080 as an expenditure tax that increases by about 9-10% for every Rand that a person's expenditure is *above* R1080. A citizen with monthly

expenditure at the break-even point of R1080 neither benefits nor loses. By financing the grant in part through excise taxes, consumers of alcohol, tobacco, fuel and motorcars have a lower break-even point, benefit less and pay more than those citizens who don't smoke, drink or drive. Citizens who the Minister of Finance has in his wisdom decided spend their money well, will benefit far more than those who he has judged to be spending their money badly.

Financing the Grant

The South African income grant considered in this paper would have the following characteristics. Every permanent resident will be individually entitled to receive a grant, but may well be encouraged to claim together with others in the same household to save distribution costs. Those who already receive other grants, e.g. the child support grant, the disability grant or the old-age pension, receive the universal income grant, but then the other grant will be adjusted downwards by the same amount. In the cases of children under nineteen years of age, the grant is paid out to the care-giver (usually the mother or grandmother). There is no means test: everyone is entitled to receive the grant, rich or poor. The grant is set at R100 per month.

The purpose of the grant is to reduce poverty. With regard to the affordability and targeting of the income grant, the crucial question is then which type of tax is used to recoup it from the affluent. The answer to this question determines both how the grant is targeted and what is the net additional burden on society of any given level of the grant.

My starting-point is that it is essential to consider the *net* impact of the grant together with the taxation used to finance it. The net impact can be very different from what one would expect when one considers the tax by itself (see also van Parijs, 2000: 11). For example, the impact of a grant plus a VAT increase (or a decision to forego a VAT decrease) has a demonstrably progressive net impact. It helps the poorest proportionally far more, for the same net increase in the tax burden, than a grant financed by an income tax increase. This in spite of the fact that VAT increases taken by themselves can be quite regressive.

A grant of R100 per month can be affordable and well-targeted if financed out of an increase in VAT, excise and other indirect taxes (or by not realising potential decreases in such taxes). This proposal is likely to be challenged both from the left, by those who argue that the net impact of any

expenditure financed out of indirect taxes is regressive, and from the right, by those who argue that the *gross* costs of at least R52 billion make the grant unaffordable regardless of how it is financed.

The fallacy in considering the gross costs of paying the grant can be exposed by imagining a situation in South Africa that conservatives would dread: a social democratic utopia where income is 100% equally distributed. In this utopia, everyone has exactly the same income and everyone has exactly the same expenditure pattern. If, under these circumstances, everyone is paid a R100 income grant, and at the same time indirect taxes are increased by just enough so that everyone also pays an additional R100 in tax, what is the actual increase in tax burden? Assuming that there is no additional cost of collecting the higher tax and paying out the grant and that everyone spends the R100 they received, it is clear that no one will be worse off and no one better off. There would be no additional *net* tax burden. The additional R52 billion in tax is promptly returned to those from whom it is collected. Under such circumstances it would be totally ludicrous to say that South Africa cannot afford an income grant financed out of indirect taxes. (It would, of course, also be a meaningless exercise, because there will be no net redistribution).

South Africa happens to be a society where income is distributed highly unequally. Suppose that a R100 grant is paid to every man, women and child legally resident in South Africa. My calculations show that this can be financed out of an increase in VAT of 7.3% (i.e. an increase of about 50% from the current rate of 14%) and a proportionate increase (i.e. of about 50%) in excise and fuel taxes. This puts a significant additional tax burden on those with high expenditures, who pay far more in extra taxes than they receive as a grant. Poor individuals spend little and will pay very little extra tax, and will therefore have a net gain as a result of the grant. If one adds together the cost to the state of all the additional net benefits received by the poor (assuming that the grants are spent so that the state can recoup some of the grant through indirect taxes), these must equal the aggregate of additional net indirect taxes (net, that is, of the grant) paid by the better off. The total in each case would have amounted to R15.2 billion in the 2000-01 financial year (see Table 1). It is only this R15.2 billion, and not the gross amount of R52 billion, that constitutes the additional burden on tax-payers. The net additional burden and the net benefit of a grant financed out of increased indirect taxes will thus be less than one third of the gross value of grant payments.[3] More than two-thirds of the money will be recouped by the increase in indirect taxes.

TABLE 1: Annual expenditure and income (R billion) on R100 universal income grant financed through increased indirect taxes.

Decile	Additional annual VAT etc (R bil)	Paid as result of increase (R bil)	Paid when grant is spent (R bil)	New Grants paid out (R bil)	Total Annual grant bill (R bil)	Annual net benefit / cost (R bil)	
1	2.4	0.8	1.6	7.1	7.9	4.7	
2	2.5	1.3	1.2	5.9	7.1	3.4	
3	2.7	1.6	1.1	5.5	6.7	2.8	Total Net Benefit: 15.2
4	2.7	1.9	0.8	4.7	5.9	2.0	
5	3.0	2.3	0.6	4.3	5.5	1.3	
6	3.2	2.8	0.4	3.8	4.8	0.6	
7	3.7	3.4	0.2	4.1	4.1	0.5	
8	4.4	4.4	0.0	3.5	3.5	-0.9	
9	7.2	7.2	0.0	3.4	3.4	-3.8	Net additional taxes: -15.2
10	13.5	13.5	0.0	3.1	3.1	-10.5	
TOTAL	45.3	39.3	6.0	45.4	52.0	0.0	

Table 1 shows that households in, say, the third decile (or tenth of South African households, ordered in terms of expenditure) would be eligible for a nominal total grant of R6.7 billion per year in income grants. Some people in these households already receive old-age or other grants, and their income grants would be adjusted downwards accordingly, such that the cost of new grants paid out is only R5.5 billion. These households will, however, pay an additional R2.7 billion in indirect tax (R1.6 billion through increased tax on existing expenditure and R1.1 billion through tax when they spend their grant income). The net annual benefit to the households in this decile – and the net cost to the state – is thus just R2.8 billion. In total, R39 billion would be collected in additional tax on existing expenditure, R6 billion would be collected in tax on expenditure arising out of grant income, R52 billion would be paid out in income grants, and R45 billion would be the new grants paid out (given that existing old-age pensioners and other grant-recipients would have their existing grants reduced by the value of the income grant).

The effective tax rate increases by about 2% for a person with monthly expenditure of R1500, increasing with expenditure to over 8% for a person

whose monthly expenditure exceeds R7000. In calculating these rates, it was assumed that the beneficiaries of the grant would spend the entire grant whereas those who have to pay additional tax would cut back on their savings rather than reduce their expenditure. If, however, people with higher expenditure levels cut back their expenditure, then a further increase in indirect taxation would be needed to finance the grant, with VAT increasing by 7.8% rather than 7.3%.

If the grants were financed out of increases in the marginal income tax rate, both the net benefit and the additional net burden would have been much higher. Very rough and ready calculations show that if the required additional income tax could be levied proportionally on all the better off households, the additional net burden would have been somewhere between R25 and R30 billion, with the latter estimate probably being more accurate (see Samson, 2002; Le Roux, 2001).[4] This is clearly far less affordable than if the grant is so financed that the net burden is about R15 billion. If the additional costs of the grant were financed out of increases in company taxes, then there would be no targeting at all of the grant. Every recipient, however rich, would have received the full benefit of the grant. The net additional burden of the grant would have been the full additional cost of R45.4 billion. This would require a tripling of the taxes on companies, which is clearly an unsustainable proposition which no one has seriously proposed.

Targeting the grant

Let us imagine that in South Africa we have an extremely efficient and omniscient bureaucracy that decides to avoid the usual pitfalls in dealing with poverty. They decide to give support only to people who spend less than R1080 per month, and to increase this support by about 9% for every Rand that the per person expenditure falls. The deeper the poverty, the higher the support given, up to a maximum of R100 a month for those who cannot afford to buy anything at all. On the other hand, the bureaucrats decide to levy a tax of on average close to 10% on everyone for every Rand of monthly expenditure in excess of this break-even point.

These highly efficient bureaucrats adjust the credits or tax every adult receives from month to month. In the month that expenditures are high, one has to pay a tax. In the months they are low, one receives a credit. The higher your expenditure, the higher the tax you pay. The lower your expenditure, the larger your credit payment, accurately calculated to the closest cent, even though you yourself may not know your actual expenditure!

Our bureaucrats are also gender sensitive. They realise that there are power struggles within households, and therefore treat everyone separately. A husband pays tax if he has a high expenditure. The wife gets a credit if her expenditure is low.

If one adds up the additional the total net benefits received by all those with a per person expenditure below about R1080 (excluding the children who were entitled to a child grant and the pensioners entitled to an old age grant), we find that the total annual net cost of all these grants is R15.2 billion, after allowing for the fact that government recoups part of the grant through indirect taxes when it is spent. Similarly, if we add up the annual tax paid by all those with a monthly expenditure above about R1080, we find the total tax income is R15.2 billion, exactly the amount needed to pay for the grant!

What our highly efficient bureaucracy has in effect done is to pay a *progressive anti-poverty grant* to the poor, financed out of an *expenditure tax* on the affluent. This is a very effective way of dealing with poverty. Even a disciple of Milton Friedman will acknowledge that it is better to take every individual's monthly expenditure as a proxy for poverty, rather than household income. If the husband hogs all the income, he may well pay a significant expenditure tax, whereas the wife may get a significant anti-poverty grant. And clearly it is far more sensible form the point of view of the poor that the payment is made monthly rather than annually. In the economic literature, since the days of Kaldor and Meade, there has been no dispute that an expenditure tax is in principle far less distortionary for economic activity than an income tax.

The problem with the preceding story is, as Sri Lanka and India discovered, that an expenditure tax is virtually impossible to implement in practice. Even in Sweden, which has a highly efficient tax administration, a commission of inquiry decided that an expenditure tax was preferable in principle but impossible in practice. No country has a progressive expenditure tax on individuals. Countries opt instead for the regressive Value Added Tax on goods and services in addition to a progressive income tax.

Exactly what we envisaged in the preceding section can, however, be achieved relatively easily in an *indirect* manner. It does not require a bureaucracy any more efficient than the one South Africa already has. In 2000-01 we could have had exactly the same results as described above, with the monthly adjustments and sensitivity to gender, if we had paid a R100 income grant to everyone and at the same time increased VAT by 7.3% and

simultaneously increased excise taxes (e.g. on alcohol and tobacco) and fuel taxes by the same proportion. This combination has an impact equivalent to that of the unworkable progressive negative expenditure tax.

TABLE 2: Benefits and costs of a monthly income grant of R100 combined with an increase in VAT and excise and levies

Decile	Cumulative population distribution (%)	Monthly per capita expenditure (R)	Monthly income grant (R)	Percentage VAT-able expenditure (%)	Monthly additional VAT, excise *and levies* (R)	Monthly *net benefit* (R)	Net benefit *(as % of* prior monthly *expend-iture)*	Recouped from grant *when net* benefit is spent (R)	*Final* cost to *govt when* benefit is spent (R)
1	15.1%	113	100	85%	10	90	80%	23	66
2	28.9%	197	100	85%	17	83	42%	21	62
3	41.8%	272	100	85%	24	76	28%	19	57
4	53.1%	364	100	85%	31	69	19%	17	52
5	63.7%	477	100	85%	41	59	12%	15	44
6	73.0%	640	100	85%	55	45	7%	11	34
7	80.9%	881	100	90%	81	19	2%	5	14
8	87.6%	1323	100	90%	121	-21	-2%		
9	94.1%	2127	100	95%	206	-106	-5%		
10	100.0%	4416	100	95%	427	-327	-7%		

From Table 2 and Figure 1 we can see how the net benefit of a universal grant of R100 combined with increased indirect taxes depends on individuals' monthly expenditure. The total increase in tax paid is equal to the increased tax on existing expenditure and the tax paid when the R100 from the grant is itself spent (and it is assumed here that all R100 is spent). Assuming that all individuals have the same average expenditure pattern, even the person who started off with no other expenditure at all costs the government not R100 but R76 in the end, when the grant is spent, because R24 is recouped by government in VAT and other taxes (see Figure 1). The net benefit is identical to the benefit of the hypothetical negative expenditure tax.

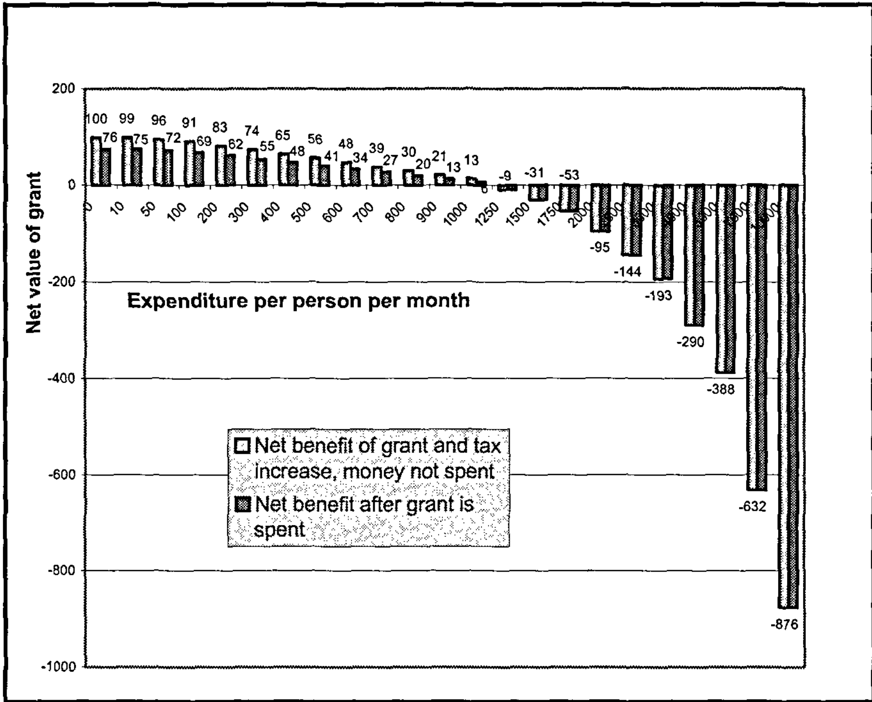

FIGURE 1: The impact of a universal income grant financed out of increased indirect taxes

This net cost, after recipients have paid taxes when spending the grant income, constitutes the actual cost to the fiscus, i.e. the additional resources required to pay for the programme. The net additional burden for government is only R15.2 billion, as it would also have been if we could in practice have implemented the negative expenditure tax.

Although VAT by itself is a regressive tax because the poor spends more of their income than the wealthy, the net impact of earmarking a VAT increase (or a VAT decrease foregone) for a universal income grant for everyone has the impact shown in Figure 2. The further one's expenditure is below the break-even point, the larger the net grant one receives in both absolute and relative terms.

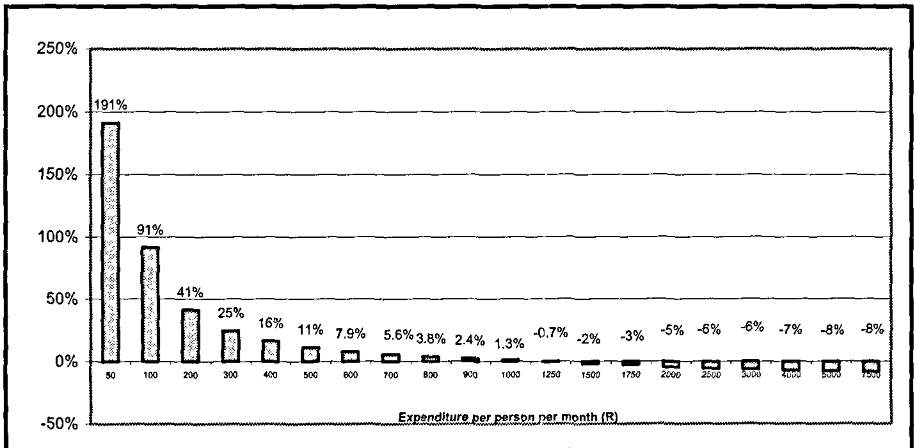

FIGURE 2: The Progressive Impact of an Income Grant Financed out of Indirect Tax Increases: Benefit/tax as percentage of monthly expenditure

The net effective tax burden will also increase from very low levels reaching about 8% with an expenditure of R5000 per person per month. Although a range of indirect taxes has been increased by a half, the more than 80% of the people who had an expenditure of below about R1080 per person per month will be better off, if, of course, they receive the R100 grant and have the average consumption pattern.

What is in fact happening is that more than R15 billion is being redistributed form those above the break-even point to those below this point. For those close to the break-even point the benefit and burdens are low. It is primarily the more affluent, with high incomes, who pay a monthly grant or remittance to the very poor. Such payments of a monthly remittance are not something new in South Africa, but up to now they have been paid mostly by people with relatively low incomes who manage to get formal sector employment and then support even poorer relatives. This new system ensures that the brunt of the cost of support for the poor is carried by the more affluent, and that the poorest benefit most, regardless whether they are fortunate to have a relative in formal employment or not.

From an analysis of the impact of this system (see Table 2 and Figures 1 and 2) it seems reasonable to conclude that, after the initial jump of 10% in price levels, there will be only very limited inflationary pressures when we

have an increase of between 7.3% and 7.8% in VAT and a proportionate increase in other indirect taxes together with a grant payment of R100 to all South Africans. After all, the position of four fifths of the population will improve rather than worsen, in spite of the once-off increase in prices when taxes are increased.[5]

The net additional burden of a well-targeted universal income grant is only a few billion Rand more than the net cost of old-age grants in the financial year 2000-2001. But the benefits will be much more widely spread than the old-age grant, which only reaches about one in four poor households. In the case of the old age grant, where the means test is fortunately not effectively implemented, the evidence is that much of the grant, particularly in the case where the grandmothers are the recipients, is well spent. Now one can expect a similar use of the grant in the case of the income grant, where about three-quarters of the money will be put into the hands of the women (as individuals and as care-givers to children). This money will firstly ensure, far more effectively than any of the existing nutrition programmes have done, that malnutrition is kept at bay. It will also facilitate school attendance. It will help the poor and unemployed to pay for training they themselves judge that they need in order to get employment. It will help with payments of water and electricity bills. It will be far more effective and cost-efficient than any of the existing micro-financing schemes in making regular funds available to those engaged in micro and small businesses. Clearly not all of the money will be well spent. But any money spent on alcohol or cigarettes will result in more being recouped by government through excise taxes (see below).

The problem of targeting a grant by increases in income tax

It was argued above that the net burden of financing a grant out of income tax will be at least double that of a grant financed out of increases in indirect taxes. The reason for this higher cost of an income tax is that higher net benefits are paid out – part of the grant is not necessarily recouped by income tax increases, even if a person's income and expenditure goes up. Those who live off dividends (on which no income tax is paid) as well as the large number of people active in the informal sector, and the far too many involved in illegal and criminal activities, and also those individuals in the formal sector with incomes below the tax threshold, will all get the full benefit of the grant even though they may have monthly expenditures of as high as a R1000 or even R2000 or more per month. For these people, the scenario of paying for the grant out of income tax increases is much to be preferred to one where

the grant is paid for out of increases in VAT and excise and fuel taxes, for they will all get exactly the same net benefit as those who have no expenditure at all.

The problem of financing a universal income grant out of increases in income tax, is that this does not guarantee vertical equity (richer people living off dividends get the full benefit of the grant, whereas poorer income earners with big families pay back part or all of the grant), nor horizontal equity (people with the same income in the informal sector get the full benefit of the grant, those in the formal sector have to pay back a large proportion or all of the grant).

There is, of course, a greater net benefit when the income tax route is chosen. Far more people get the full benefit of the grant – and correspondingly a greater burden too, but this benefit is not well targeted to deal with the depth of poverty. People with high monthly income and expenditures could well get the same net benefit of R100 as those with no expenditure at all.

If we should decide that society should be willing to accept the net additional tax burden of at least R25 billion imposed by a R100 grant that is recouped by income tax increases, we could for the same net burden afford a grant of about R175 and recoup it by increases in indirect taxes. A R175 grant thus financed would clearly mean a much larger net grant for the very poor, but many of the better off who do not pay income tax, but who cannot avoid paying income tax, would be worse off under such a scenario. Those in destitution will, in fact, for a given tax burden, always benefit more from a grant targeted by increases in indirect taxes, rather than from a grant financed out of increases in income tax (see le Roux, 2001).

Unintended but not necessarily undesirable consequences: Giving Ms Clean Living Green a higher net benefit

Let us return to our highly efficient and omniscient bureaucrats, and assume that they, in spite of strenuous objections by the anarchists from the left, decide to favour clean living individualists of all persuasions. Although everyone with zero expenditures get a R100, the non-drinking, non-smoking and non-petrol consumer has her grant decreased by less than 7% with increases in expenditure, which means that these individuals keep on getting a net grant up to a monthly expenditure of about R1500 (rather than the decrease of more than 9% and a break-even point of about R1080 which would apply to citizens with the average mix of sins).

The heavy drinker and smoker who also drives around in a gas guzzling car is severely penalised. His grant, which is also R100 when he has no expenditures and therefore cannot sin, decreases by about 17%, so that he already starts paying tax instead of receiving a grant at an expenditure of about R600 a month! What is more, not only does he start paying tax at a much lower threshold, but his tax increases at a rate of 17% per month instead of the 9-10% of the ordinary taxpayer, and the less than 7 % of his green and clean living neighbour or partner.

The bureaucrats vigilantly monitor ones behaviour from month to month – when the sinner decides to live cleanly, he immediately gets rewarded, and when Ms Clean Living Green sins, she is immediately punished. Our omniscient bureaucrats, knowing exactly what mix of sinful and approved expenditures each individual has, applies the specific rate applicable, and pay out a net grant or levy a net tax accordingly.

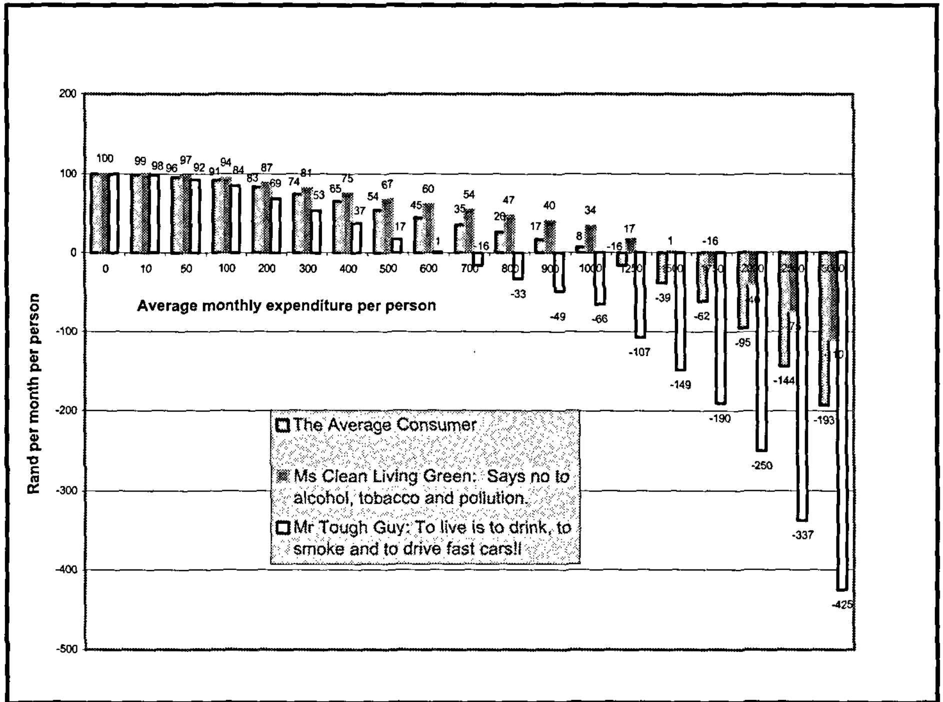

FIGURE 3: The Discriminatory Effects of Increasing Sin and Fuel Taxes

Exactly what has been described in the preceding paragraph, will in fact happen automatically, without knowing any individual's pattern of expenditures, if the grant is financed by increasing VAT, excise taxes and fuel taxes by half (see Figure 3). The reason for this moralistic bias of such proportionate increases is that the excise taxes and fuel taxes are already much higher than the ordinary VAT rate, and a 50% increase in them would thus impose a higher additional burden than merely a 50% increase in VAT. This would thus penalise those who disproportionately spend on these goods – and the more they are inclined to spend on the goods which our Minister of Finance has burdened with high sin taxes, the greater the effective expenditure tax they face. (Exactly how bad the impact for Mr Tough Guy would be, depends on how tough he is, but at worst it could be about as bad as is shown in Figure 3). Those who have no expenditure on any of these goods, will on the other hand, receive a much higher net grant up to a much higher level of expenditure, and will pay a lower effective tax rate once past this high break even point. Given the often expressed fears that many will misuse the grant by wasting it on alcohol and cigarettes, this is clearly a significant outcome.

Avoiding poverty traps

Financing an income grant through indirect taxes avoids the problems of poverty traps and dependency. This makes it preferable to a means-tested income grant, where government spending is targeted precisely on the poor but the poor may easily be trapped in poverty.

One way of measuring poverty is via the 'poverty gap'. The poverty gap is the amount needed to bring the expenditure of all those under any defined poverty line up to the poverty line. Bhorat (2002) estimated that in 1999 the poverty gap in South Africa was R12.8 billion if the poverty line was set at R400 per month, and that a R100 per person universal income grant would eliminate 2/3 of this gap (see also Haarmann, 1998; Samson *et al.*, 2002). If income transfers could be targeted on the poor precisely, it would only cost R13 billion (plus administrative costs), i.e. roughly what was spent on pensions in 1999, to eliminate poverty in South Africa. It can be argued that, under these circumstances, South Africa should adopt a system similar to German social assistance (*Sozial Hilfe*) or the English dole system, topping up the income of poor households and (using a stringent means-test) only these poor households.

The problem with such an approach is that, in the very attempt to help people out of poverty, many may be trapped permanently into poverty. In

contrast to the pension payments, dole payments and other means-tested social assistance programmes punish those poor people who help themselves (see Standing, 2002: 53). The application of a means-test has the effect of imposing a high tax rate on any additional income earned by a poor person receiving social assistance: for every extra Rand the poor person earns, he or she loses some amount through a reduction in their means-tested grant. In some cases, the tax rate might be more than 100 percent, if the additional earnings pushes the person over an income threshold that renders them ineligible for social assistance. A culture of "not doing anything for oneself and depending on the state grant" could very easily be created. Through the process of means tested targeting one runs the risk of creating a second-class citizenry, destroying some people's own worth and initiative.

There are two very important differences between the universal income grant system proposed for South Africa and the dole and social assistance system in Europe. Firstly, R100 a month in 2000-2001 was only about one third to one quarter of the poverty lines generally used, in contrast to the social assistance in northern Europe, which usually suffices to raise people out of poverty. This grant is sufficient to address destitution, but not to eradicate poverty.

If a grant of R400 or R600 per person could be financed, one could still argue that some recipients might sit back and not try and do anything for themselves, thinking that they can live on the grant. At a level of R100 this surely will not be the case. Secondly, the proposed universal income grant is not means-tested. Everyone get the full grant and loses nothing when they start working or when they earn money in any other way. This means that poor people still have an incentive to find work and earn money.

Phasing in an income grant

A universal income grant may be 'affordable', but it does not follow that South Africa can readily opt for such a grant. Whilst the South African Revenue Services has the capacity to levy indirect taxes efficiently, it is also necessary to have an efficient and cost effective delivery system for the new grants. It would not make sense to opt for the income grants proposed here if the cost of delivering them is high relative to the net benefit to the poor.

A universal income grant in South Africa could entail as many as 20-25 million payments per month, assuming that grants for children would be paid to their care-givers. This figure is more than ten times the number of

pensioners being paid each month, and four or five times the number of number of eligible beneficiaries of all existing social assistance programmes. The administrative and logistic problems will be immense. How does one ensure that only South Africans and those who are permanently registered in South Africa receive the grant? How does one make sure that one stop people claiming more than one grant, perhaps in different provinces? How does one prevent theft, given that monthly payments of about than R4 billion will invite cash heists?

If the cost of delivering the grant amounts to 20% of the *gross* grant total, or about R9 billion, then it the money paid out to the institutions delivering the grant would be more than half the *net* benefit people receive. This would undermine one of the strongest arguments for a universal income grant, viz. that it reaches those most in need of help.

Eventually the cost of delivery may not constitute a serious problem. Once every South African, as envisaged by government, has a 'Hanis smart card' as an ID card, it will be possible to register people for the grant at any financial institution by using this card combined with a fingerprint reader. It will be possible, I have been assured by those in Home Affairs responsible for this project, to control centrally that no one registers more than twice. It is not clear yet what is to be done in the case of children under sixteen, who will not have a Hanis card, should the age for registration be extended downwards; children will not be able to claim, but before their payments can be made to their care-giver, there has to be a system of registration which avoids dual or triple registration. In the end every South Africa will have to have a Hanis card if this system is to work. In the case of young children, footprints may have to be used instead of fingerprints.

The Hanis card could also have a wallet and facilities for debit and credit cards. If many spaza shops, even in the remotest areas, should acquire the machines which can read fingerprints and connect with a bank (even by using solar electricity combined with dynamo systems, and communicating via the cellular phone system), it may be possible to make the payments electronically everywhere. As is envisaged in NEPAD, South Africa will have to jump the digital divide and move in to the era of electronic money very rapidly. Monthly, on the day that the claimant has his or her birthday, the electronic money can be downloaded, then kept electronically on the wallet or used for purchases. People can opt for either or both of fingerprint protection and a pin number.

This system would require massive initial outlays. But once it is in place, it should be able to deliver the grant at a cost not more than 5% of the gross amount, and possibly at one as low as 2½%. Now – in 2002 – this might sound like science fiction, but those in the know in the Reserve Bank and elsewhere argue that this all is already possible today. What would be needed before government could seriously consider the introduction of a universal income grant is to have an in depth investigation of the future options available for the effective delivery of a grant. Only if it can be shown beyond all reasonable doubt that this can be done, should the government commit itself to what otherwise seems to be the ideal policy measure to deal with destitution and poverty.

Delaying or phasing in the introduction of an income grant has implications for the tax increases needed. Since it will take at least three to four years to develop the systems needed to deliver the grant effectively, government could find the finances for part of the cost by not giving any further income tax reductions (such as those made during the past few years) made possible by ever more efficient tax collection. The saved tax revenues should be earmarked for the universal income grant, for example through phasing in the income grant by raising the age limit for payment of the existing child support grant. Thus, although a R100 grant would in the financial year 2000-2001 have required a an increase in VAT of between 7.3% and 7.8% and a proportionate increase in other indirect taxes, in three years time much smaller VAT increase should, under reasonable assumptions, suffice to pay for a grant of R100 adjusted for inflation. I calculate that the necessary increase in VAT would be about 4%-5%, i.e. from the present 14% to a new rate of 18% or 19% (and proportionate increases in the other taxes). The effects of this are shown in Figure 4. The average consumer would only start carrying a net tax burden at R1750 per person per month expenditure. At a monthly expenditure of R4000, the effective increase in the tax rate would be about 2.8%. The maximum increase in taxes would be about 5%, reached at the extremely high rates of per person expenditure of R20000 per month.

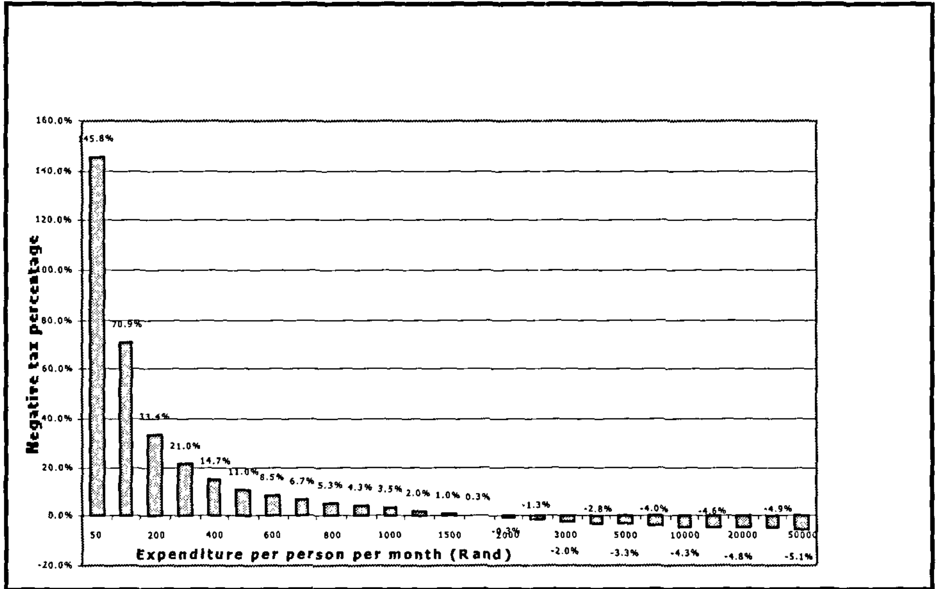

FIGURE 4: Effective Negative Expenditure Tax Rates of Income Grant Combined with 4% Increase in VAT and Proportional Increases in Other Taxes

Why this type of system has not been implemented elsewhere in the world

South Africans often ask why we should opt for a universal income grant when no other country (except for the state of Alaska, and then for reasons unrelated to poverty issues – see Goldsmith, 2002) has opted for such a programme. Even one of the major proponents of an income grant, the Belgian philosopher Philippe van Parijs (1995), has argued that developing countries cannot effectively implement a universal grant and should rather opt for a more limited means tested targeting.

In Europe, the existence already of social assistance programmes lifting the poor above the poverty line means that proposals for an income grant have been rejected on cost grounds. In Britain, the Meade Commission proposed that a universal income grant be financed by increases in VAT.

As Atkinson (1773: 8) writes:

> The problem with introducing such a scheme in Britain is that the introduction of a social dividend guaranteeing an income at the level of the present supplementary benefit scale would involve a substantial cost. According to the estimates given in a recent article by Meade, for example, the basic rate of tax would have to exceed 50 per cent. This, and other considerations, led the government to conclude that 'a complete merger of income tax and social security – whatever its theoretical attractions – is impracticable'.

At the moment the European country which seems to be taking the idea of a basic income most seriously is Ireland, where an official Green Paper on this issue has recently been published (see Healy and Reynolds, 2002). Again, the cost factor is militating against the proposed grant being accepted in practice.

No one seems to have investigated the potential of setting grants *below the poverty level* in the case of developing countries, nor the efficacy of combining a grant plus VAT increases to target the poor (and tax the rich). In the South African case, because there is no pre-existing social assistance for most poor people, a grant of even R100 is acceptable to the left, even though this is one quarter or less of what should be a minimum poverty line. Most people realise, as also can be seen in Figure 2, that this will significantly improve the situation of the many millions of South Africans in the four deciles. Had South Africans insisted on a grant of R600 per month then it would have been necessary to push VAT up to a level of 48%, i.e. a rate that is punitive even for those in relatively low expenditure categories. It would clearly not be possible to implement this type of tax increase without very negative consequences for the economy. What is more, such a high tax rate means that, although the poor received a grant of close to R600, the net benefit would be less than half of this because so much goes back to the government in indirect taxes once the poor spend their grant. This will leave many people well below the poverty line. South Africa is not yet caught up in the European system of high minimum grants, and therefore has the option of going the more rational alternative route of providing a lower grant that can wipe out destitution and significantly reduce the poverty gap.

In the 1960s, when Friedman first proposed his negative income tax, there was an alternative proposal that the USA should rather go the route of paying a universal grant and fund it by increases in the VAT. Again, however, there was no explicit discussion of the fact that this would in effect mean a progressive grant for the poor below a break-even point and a progressive expenditure tax for the affluent. These proposals never seemed to have entered mainstream discussion, possibly because of constitutional

objections to a federal VAT. A negative income tax – i.e. equivalent to grant or tax credit that is inversely related to household income – was seriously considered in the USA and also got much attention in Britain. Most proposals pitched it at a level high enough to ensure that the recipients would be above or close to the poverty line. This made it very expensive, and also lead to a reduction of work effort by some recipients (particularly the spouse, although at the same time it lead to an increase in the participation rates of African American men) in the extensive experiments that were conducted. In the end the concept was modified, and the USA opted for an Earned Income Tax Credit (see Standing, 1999:306-307). The income tax rules were amended to require government to pay an annual credit according to a specific scale to low income earners who have a child or children. This has become a very important method of enhancing the income of the poorer households in the USA. A similar system (Working Families' Tax Credit) was adopted in the UK, where the requirement that the there must be children in a household before the grant is paid out, will soon be scrapped. France also recently opted for a similar approach when Prime Minister Fabius introduced the *prime pour l'emploi.*

These countries have all accepted the arguments of Friedman and other economists that traditional means tests create poverty traps, and have opted to help the poor in a way that will not discourage them from also doing something for themselves. Particularly in the USA, the Earned Income Tax Credit has lead to a very significant redistribution of income to the low-income earners in a way that does not punish initiatives by the poor themselves. These measures do not, however, address poverty when people are unemployed. It would, for this reason, not be sensible to introduce a similar system in the South African context. Here, because of our much, much higher rate of unemployment, most of the really poor families do not have anyone in formal employment, and they will thus not benefit.

The alternative proposed here is particularly suitable for developing countries with high-income inequalities[6], with an efficient indirect tax system, and with the ability to develop the systems to deliver this grant only to citizens and permanent residents. One of the reasons why the possibility to target support for the poor by a universal income grant financed out of an increase in indirect taxes has not been properly investigated before is surely that very few countries combine these characteristics. In fact, it is only recently, with the development of the smart card, which can contain biometric details of every citizen, and can also include a wallet, that this type of system

can be seriously contemplated. South Africa, Namibia and Brazil are probably among the few countries where these conditions are met, and it is thus not surprising that these are the countries where the option of a universal income grant is now on the agenda.

Even in these countries it will require a very concerted effort to implement this type of system. This puts an additional obligation on South Africa to consider taking up the pioneering task of introducing this system. South Africa is one of the few developing countries that has the communications infrastructure and the technical know-how needed to jump the digital divide and put in place the systems needed to deliver electronic money effectively even in the deep rural areas. We already have a relatively efficient Revenue Authority in place. The proposal I have put forward in this paper is in line with government's intention to deal effectively with poverty and it is complimentary to NEPAD. South Africa has a unique opportunity to implement a very innovative and effective social security system that can eliminate destitution over night. Clearly more work ought to be done before South Africa commits itself to this option, but this is an option which in our context justifies very serious attention.

Pieter Le Roux is Director of the Institute for Social Development and Professor of Development Studies University of the Western Cape, Private Bag X17, 7535 Bellville, South Africa. E-mail: Pleroux@uwc.ac.za. He has long been involved in research on social welfare, and has served on a series of government commissions including the Mouton, Smith and Taylor Committees.

References

Atkinson, A. 1973. *The Tax Credit Scheme and the Redistribution of Income.* Institute for Fiscal Studies Publication no 9, London.

Atkinson, A. 1977. 'Optimal Taxation and the Direct versus Indirect Tax Controversy'. *The Canadian Journal of Economics,* 10(4), pp.590-606.

Atkinson, A. 1994. *Public Economics in Action: The Basic Income/Flat Tax proposal,* The Lindahl Lectures. Claredon Press, Oxford.

Barberton, C. 2002. 'Comments on Chapter 14 of the Draft Consolidated Report of the Committee of Inquiry into a Comprehensive System for Social Security for South Africa'. Occasional Paper, IDASA, Cape Town.

Bhorat, H. 2002. 'A Universal Income Grant Scheme for South Africa: An Empirical Assessment'. Paper presented at the 9th International Congress of the Basic Income European Network, Geneva, September 12th-14th.

Duflo, E. 2000. 'Grandmothers and Granddaughters: Old Age Pensions and Intra-Household Allocations in South Africa'. *Working Paper* 8061. National Bureau for Economic Research: Cambridge, Massachusetts.

Friedman, M. 1962. *Capitalism and Freedom.* University of Chicago Press, Chicago.

Goldsmith, S. 2002. 'The Alaskan Permanent Fund Dividend: An Experiment in Wealth Distribution'. Paper presented at the 9th International Congress of the Basic Income European Network, Geneva, September 12th-14th.

Healy, S. & Reynolds, B. 2002. 'From Poverty Relief to Universal Entitlement: Social Welfare, Minimum and Basic Income in Ireland'. Paper presented at the 9th International Congress of the Basic Income European Network, Geneva, September 12th-14th.

Kaldor, N. 1955. *An Expenditure Tax.* George Unwin & Allen, London.

Le Roux, P. 1999. 'The value of a basic income grant in SA'. *Financial Mail,* 20th August.

Le Roux, P. 2001. 'The Case for A Basic Income Grant in South Africa'. Unpublished paper. July 9, Institute for Social Development, University of the Western Cape and Center for Health and Wellbeing, Woodrow Wilson School, Princeton.

Le Roux, P. 2002. '*The benefits of a basic income in South Africa'.* Paper presented at the 9th International Congress of the Basic Income European Network, Geneva, September 12th-14th.

South Africa. 2002. *Transforming the Present, Protecting the Future.* Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa, RP/53/2002.

Standing, G. 1999. *Global Labour Flexibility, Seeking Distributive Justice.* Macmillan Press, London.

Standing, G. 2002. *Beyond the New Paternalism: Basic Security as Equality.* Verso, London & New York.

Van der Berg, S. 2002. 'The BIG Grant: Comments on the Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa'. Viewpoint, South Africa Foundation, July. Johannesburg.

Van Parijs, P. 1995. *Real Freedom for All. What (if anything) Can Justify Capitalism?* Oxford University Press, New York.

Van Parijs, P. 2000a. 'A Basic Income for All'. *Boston Review.* http://bostonreview.mit.edu/BR25.5/vanparijs.html

Van Parijs, P. 2000b. 'Philippe van Parijs Responds'. *Boston Review.* http://bostonreview.mit.edu/BR25.5/vanparijs2.html

Notes

1 This is a greatly shortened version of a paper which has gone through a series of revisions. The final full version – entitled 'A Targeted and Affordable Universal Income Grant for South Africa' – was delivered at the DPRU/FES Conference on Labour Markets and Poverty in South Africa, Johannesburg, October 2002.

2 See Le Roux (2001), the July 9 version of my unpublished paper in which most of the arguments put in this paper were first developed. This paper was made available to Treasury. For two reasons the estimates made in that paper of the net additional tax burden when financing a universal income grant are somewhat lower than those presented in this paper. Firstly, it was assumed there would be a 95% and not a 100% take up of the grant. Secondly, that paper unrealistically assumed that everyone's expenditure would increase by the full value of the grant, rather than only by the net benefit they receive (see below for the assumptions made in this paper). Nevertheless, the arguments that paper developed as to the relative cost and benefit of different financing options for a grant and the relative cost of different levels of grants hold, even though the actual estimates have to be adopted upwards by roughly about 1% in the case of the VAT estimates to be in line with those presented in this paper.

3 Net costs as proportion of gross costs seems to be about equal to the square of the Gini coefficient. In the case of the social democratic utopia postulated above, the Gini coefficient is zero and so is the proportion of the net to gross costs. In South Africa, with a Gini coefficient of .58, this proportion is about $^1/_3$, in the case of a Namibia, with a Gini coefficient of 0.7, this proportion is about a half, and in the theoretical situation of a Gini coefficient of 1, this proportion would also be 1. The more equal the distribution of income, the less the effective redistribution as a result of a universal income grant financed by an increase in indirect taxes, and the higher the indirect tax increase needed to finance a reasonable net transfer to the poor. The grant system proposed here thus only have a significant impact in countries with relatively high Gini coefficients.

4 Far more sophisticated models are needed to estimate better the net impact of increases in income tax. Such models have been developed by Holly Sutherlands (Cambridge University) and used by Atkinson (1994) to estimate the impact of a basic income financed by flat income tax.

5 If the grant and tax increases are introduced simultaneously, it will be clear that the vast majority of workers are in fact better off, and this would mean that there should not be broad pressures for increases in wages. However, more work needs to be done on the impact of the increase in fuel prices etc. to be confident of this conclusion.

6 It is essential that there must be a sufficient number of high income earners in the top three household deciles to make it possible to finance a grant which can address destitution by relatively moderated increases in indirect taxes. In a country such as Rwanda calculations I have done shows that one will at this stage of its development have to have a very high increase in indirect taxes (because of the small base of high income earners) in order to raise sufficient funds to pay a meaningful grant.