Submission to the Standing Committee and Select Committee on Finance with respect to the proposed 2018 National Budget

Submitted by:

Submission endorsed by:

Due to timeframes the committee will be provided with a list of organisations endorsing these submissions by Wednesday 28 February

For further information contact:
Gilad Isaacs: CSID, University of the Witwatersrand|gilad.isaacs@wits.ac.za| 082 786 2473
Zukiswa Kota: Public Service Accountability Monitor | z.kota@ru.ac.za | 072 648 3398
Russell Rensburg: Rural Health Advocacy Project | russell@rhap.org.za | 079 544 3317
Neil Coleman: Institute for Economic Justice |082 776 5018
Daniel McLaren: Section27 | mclaren@section27.org.za | 079 9101 453
Hopolang Selebalo: SPII| hopolang@spii.org.za | 011 833 0161
Roné McFarlane: Equal Education|rone@equaleducation.org.za
Samantha Waterhouse: Dullah Omar Institute | swaterhouse@uwc.ac.za | 084 522 9646
Mervyn Abrahams | mervyna@pacsa.org.za | 033 342 0052
Paula Proudlock: Children's Institute | paula.proudlock@uct.ac.za | 083 412 4458

Summary

As civil society organisations we are alarmed at the regressive taxation measures proposed in the 2018 Budget Speech, particularly the proposed VAT and fuel levy increases. While we recognise the need to raise additional revenue for the national fiscus, the proposals made to Parliament by Minister Gigaba make the tax regime more regressive and stand to exacerbate already unacceptably high levels of poverty and inequality and retard job creation and economic growth.

We are concerned that the negative effects this will have on the poor, detailed in this submission, have not been adequately considered. We also demonstrate that alternative progressive taxation measures, which would reduce inequality and support growth, are available to the Executive.

The budget proposals put to Parliament include:

- A one percentage point increase in the value-added tax (VAT) rate combined with significant increases to excise duties and the fuel levy;
- A very modest increase in effective personal income tax (PIT) rates through below-inflation adjustments to tax brackets;
- No increase in the corporate income tax (CIT) rate;
- Very limited increases on property taxes;
- New environmental and health taxes;
- Below inflation increases to medical tax credits.

When proposing changes to the tax structure existing imbalances should first be noted so that priority can be given to correcting these, rather than worsening them through regressive measures such as VAT increases. Important general trends include:

- **Tax mix**: CIT has fallen as a share of the tax mix and continues to fall under the proposed budget. VAT is projected to rise. Property taxes make a negligible contribution.
- **Tax rates**: PIT effective rates have been in long-term decline with a recent modest uptick. CIT rates have been in long-term decline and have remained static since 2008. Excise duties have risen steeply. Property taxes have remained similar in recent years.
- **Comparisons**: Contrary to the assertion by the Minister of Finance, South Africa does not have high PIT and CIT rates by international comparison.

We are concerned about the rise in indirect taxation (VAT, excise duties and the fuel levy) because:

- **These are the least progressive taxes**. The cumulative share of indirect taxes paid by the lowest 70% of income earners exceeds their cumulative share of disposable income.
- **Increases to these taxes are therefore likely to exacerbate inequality and poverty**.

- **The poor are not adequately protected from a VAT increase through existing zero-rating measures**. While beneficial, less than half of the poor's food basket is spent on zero-rated goods, not all zero-rated goods are optimally targeted and many other essential goods are not zero-rated (such as canned beans, margarine and soap). Food consumption patterns mean that an increase in VAT actually has the potential to push the poor away from zero-rated items. Considerably more is spent on tax breaks for higher-income earners than on zero-rating.
- **An increase in VAT will also be at considerable cost to the state** through its purchase of goods and services. This will put additional pressure on public services (including basic education, housing and health care) which are already facing funding cuts in this budget.

The tax measures proposed must be viewed in the wider context of financial strain faced by poor households. In particular:

- **Increases to social grants** have barely kept pace with CPI inflation and often lag behind food price inflation. Increases to social grants also lag significantly behind increases on excise duty and the fuel levy. The spending power of the poorest is already being eroded.
- **Poverty and unemployment have risen in recent years and wage growth for the majority is weak**. This indicates that there is little ability for those with low incomes to absorb the tax increase.

We do not accept the unsubstantiated assertion by National Treasury that an increase to VAT will "have the least detrimental effects on economic growth and employment over the medium term". The National Treasury also fails to consider that:

- Section 9 of the Constitution requires the state to "promote the achievement of equality" through "legislative and other measures designed to protect or advance persons … disadvantaged by unfair discrimination" and by not unfairly discriminating against such persons. This means that regressive taxation measures may violate fundamental obligations in the constitution.
- Raising VAT can increase inequality while raising PIT, CIT and taxes on property can reduce inequality. This is important because inequality leads to negative social outcomes and reduces economic growth.
- There is little robust evidence that indicates that the dramatic falls in PIT and CIT have had a growth enhancing effect on the local economy.
- Arguments that personal and corporate income tax rates must be kept low to maintain international competitiveness risk a "race to the bottom".

We believe there are alternatives to the current budget proposals that would make the tax system more, not less, progressive. Among these are:

1. **Increasing *ad valorem* excise duties on luxury goods** and expanding the number of goods covered by these taxes.

2. **Expand zero-rating** to include more items commonly consumed by low-income groups, with particular attention to the needs of women and children, and review existing zero-rated items to assess how they can be optimally targeted.
3. **Institute a higher VAT rate on luxury goods** that could also offset any revenue lost due to expanding zero-rating.
4. **Reduce tax breaks that predominately benefit higher-income households** (such as on pensions and medical aid).
5. Make up the necessary revenue gap through **an increase in effective tax rates on PIT, CIT and property taxes**.

These are elaborated upon below.

We are concerned further that current revenue raising does not offer enough funds for government to cover vital social needs. In this context, we may need a more ambitious revenue raising approach which increases the tax-to-GDP ratio. We are also concerned that the rate at which debt is set to be reduced entails cut backs in spending that will retard economic growth and could be counter productive to reducing debt levels and ensuring economic growth in the medium term.

We call on Parliament to:

1. **Withhold approval of the tax proposals**, in particular the increases to indirect taxes, including keeping VAT at its current level of 14%.
2. Institute a **proper process of public engagement** regarding the optimal revenue raising mechanisms.
3. To **review the processes of public participation** – its timeframes, format, and implementation – which presently limit public participation in the budget process.
4. **Require National Treasury to**:
    a. **Make available, in full, the evidence** upon which it bases its claim that rising direct taxes (such as PIT and CIT) is harmful to economic growth, including the assumptions and models upon which these are based.
    b. **Provide detailed evidence regarding the distributional effects of its proposals**.
    c. **Provide evidence and reasoning regarding the level and rate of proposed contraction in borrowing** in light of optimising potential economic growth.

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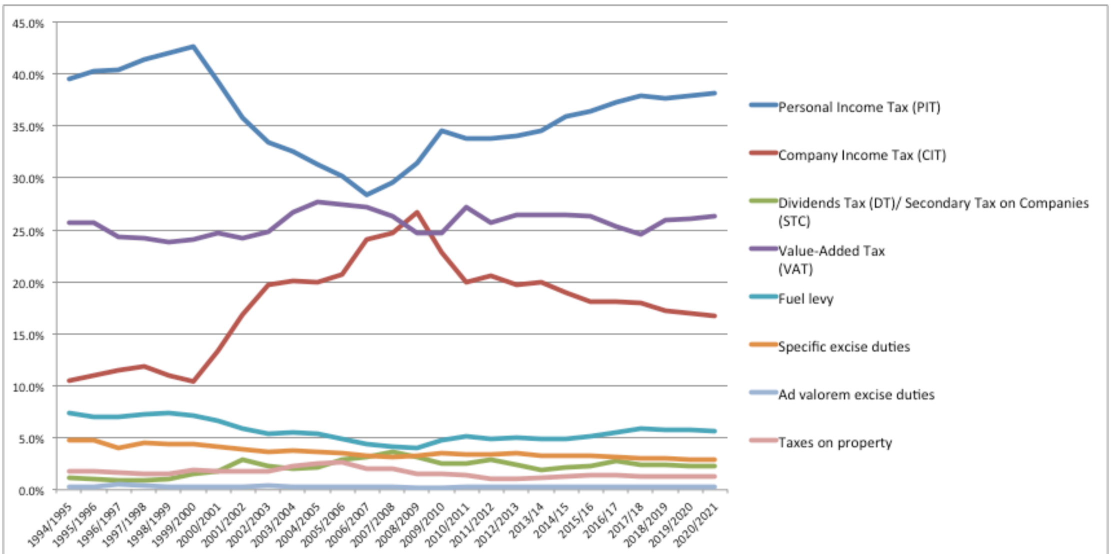
1. General trends in revenue shares

Figure 1 shows the share of taxes collected by different tax categories between tax years 1994/1995 and 2020/2021, with the last four years as estimates.[1] A number of important historic trends stand out:

- The share of revenue from **personal income tax (PIT)** fell from 43% in 1999 to 30% in 2007. This is despite strong growth in the number of PIT taxpayers and significant wage growth amongst higher-income earners. It is largely due to falling PIT rates and strong corporate profits, and the consistently high share of VAT. PIT's subsequent rise as share of revenue corresponds to weak corporate profits post 2007/2008.
- The share of **corporate income tax (CIT)** in the overall tax mix rose prior to 2007/2008 on the back of strong corporate profits, and better tax collection, and fell subsequently with slower economic growth.
- **Valued-added tax (VAT)** has contributed 24% - 27% of tax revenue and been held constant at a rate of 14% since 1993 (after increasing from 10%).
- **Dividend tax** peaked in the 2005/2006 – 2011/2012 period around 3%. Before 1999/2000 it hovered around 1% and in other years around 2%.
- The **fuel levy fell** from around 7% in the 1990s to average 5.1% between 2000/2001 and 2014/2015, it then rose from 4.9% in 2014/2015 to 5.9% in 2017/2018.
- From 2004/2005 onwards **excise duties** have ranged between 3 and 3.5% and ***ad valorem*** **excise duties** between 0.2 and 0.3%.
- **Taxes on property** rose in the early 2000s from 1.8% in 1999/2000 to a high of 2.7% in 2005/2006 only to fall by half to 1.3% in 2017/2018.

Figure 1 Tax trends: different tax categories as share of total tax revenue (1994 /1995- 2020/2021)



Source: National Treasury, Budget Review 2018 and Budget Review 2008

Going forward it is notable that:

- **VAT will increase its share** in the tax mix from 24.6% in 2017/2018 to 26.3% in 2020/2021.

[1] The categories shown will not add up to 100% as not all categories are included and some overlap in the content.

[2] Nora Monkam, Ingrid Woolard, and Tania Ajam, 'Macro Analysis of the Tax System and Inclusive Growth in

- **CIT will make up a *declining* share** in the tax mix, from 17.9% in 2017/2018 to 16.7% in 2020/2021, continuing its downward trajectory.
- **Excise duty and ad valorem excise duties will remain largely flat** as a share of revenue (despite large increases in their rates).
- **Dividend tax will fall marginally**, from 2.4% of total revenue to 2.3%.
- **Taxes on property will remain constant** at 1.3% of total revenue.
- The **fuel levy will remain high** at 5.7 – 5.8% compared with 4.8% in 2014/2015.

The significance of these trends will be unpacked in the relevant sections below.

2. Indirect taxation

"Indirect taxes exacerbate poverty – in the absence of indirect taxes the poverty rate (using PPP$1.25 per person per day poverty line) would fall to 11.7% [from 34.4%]" – Davis Tax Committee[2]

In South Africa, indirect taxation – comprising VAT, excise duties, and the fuel levy – is regressive. For a progressive tax the rich would pay a higher *share of the tax itself* and this would constitute a higher *share of their disposable income*. Naturally, because the wealthier earn and spend more they will pay a larger proportion of the rand value of indirect taxes, and a larger proportion of any increase – but this is besides the point when analysing the impact of an increase to these taxes for the livelihoods of the majority of South Africans. Particularly, when considering the impact on the poor we need to concentrate on the *share of disposable income* this tax takes up.[3]

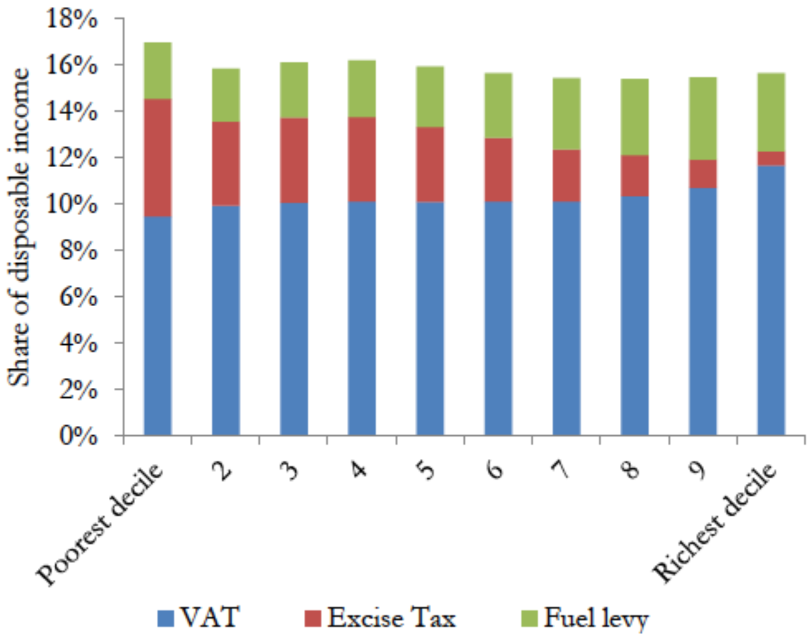
Combined these taxes form a larger share of the disposable income of the poorest – the richer pay a slightly higher share of their income on VAT and the fuel levy, but excise duties – taxes on alcohol and tobacco – hit the poor the hardest. This is shown in Figure 2, drawn from a World Bank report by Inchaste et al. (2015). The report notes that the cumulative share of indirect taxes paid by the lowest 70% of income earners exceeds their cumulative share of disposable income.[4]

[2] Nora Monkam, Ingrid Woolard, and Tania Ajam, 'Macro Analysis of the Tax System and Inclusive Growth in South Africa' (Davis Tax Committee, April 2016), 54, http://www.taxcom.org.za/docs/20160421%20DTC%20Macro%20Analysis%20Final%20Report%20-%20Full%20Report.pdf.

[3] This is the reason that the Budget Review's comment that the "wealthiest 30 per cent of households contribute 85 per cent of VAT revenue" is both obvious and meaningless when assessing the social consequences of the VAT hike (National Treasury, Budget Review 2018, p. 44).

[4] Gabriela Inchauste et al., 'The Distributional Impact of Fiscal Policy in South Africa' (The World Bank, 1 February 2015), 18, http://documents.worldbank.org/curated/en/502441468299632287/The-distributional-impact-of-fiscal-policy-in-South-Africa.

Figure 2 Share of disposable income spent on indirect taxes by income decline



Source: Inchauste et al. (2015) p. 19

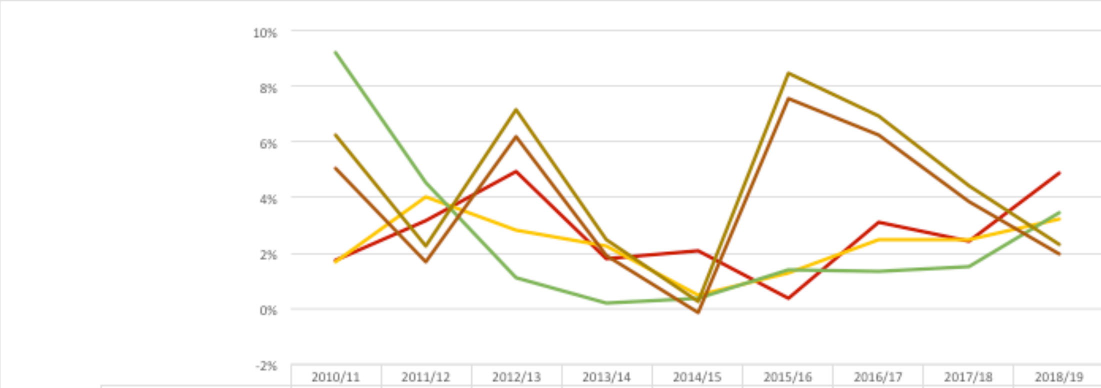
For these reasons, as the Davis Tax Committee (DTC) notes, increases to indirect taxes can exacerbate poverty and inequality.[5]

Taxes on excise duties and the fuel levy have risen significantly and consistently in recent years while the general trend in CIT and PIT effective rates has been downward or flat, with modest PIT rate increases in recent years. This is shown in Figure 3 which indicates, between 2010/2011 and 2018/2019 an average *real* annual increase in excise duties of around 2.5% for the products selected and an average *real* annual increase of 3.8% and 4.5% for the fuel levy on petrol and diesel respectively (this will be compared to increases in social grants below). This indicates that taxes that hit the poor hardest are rising at a faster rate than taxes that mainly target higher income earners and companies. In this budget proposal this regressive trend is again reinforced as:

- VAT is proposed to rise from 14% to 15%.
- The fuel levy is proposed to rise by 3.9 and 4.4% in real terms for petrol and diesel respectively (52 cents per litre).
- Excise duties are proposed to rise between 6% and 10%.

[5] Monkam, Woolard, and Ajam, 'Macro Analysis of the Tax System and Inclusive Growth in South Africa'.

Figure 3 Real annual percentage increase in excise duties and fuel levy (2010/2011 – 2018/2019)



	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Beer (malt)	1.8%	3.2%	4.9%	1.8%	2.1%	0.4%	3.1%	2.4%	4.9%
Wine (unfortified)	1.7%	4.0%	2.8%	2.3%	0.5%	1.3%	2.5%	2.5%	3.3%
Cigarettes (20 pkt)	9.2%	4.6%	1.1%	0.2%	0.4%	1.4%	1.3%	1.5%	3.5%
General fuel levy (petrol)	5.0%	1.7%	6.2%	1.9%	-0.1%	7.6%	6.2%	3.9%	2.0%
General fuel levy (Diesel)	6.3%	2.3%	7.2%	2.5%	0.3%	8.5%	6.9%	4.4%	2.3%

Source: National Treasury, Budget Review 2018, Table 4.4 and 4.7; SARB, Tax Chronology of South Africa 1979-2016, pp. 26, 28

These indirect taxes will make up a larger share of the revenue mix rising from 33.5% in 2017/2018 to 34.8% in 2020/2021. This is in contrast to trends across the OECD where the contribution of these taxes has fallen.[6]

Regarding excise duties, we appreciate that these are instituted in order to achieve various social goals – the reduction of smoking and alcoholism, and through that an improvement in public health, a reduction in health expenditure and the curtailing of violence, particularly against women and children. We support these objectives. We also note that these excise duties have had some success in this regard.[7] At the same time we do not wish to unduly tax the poor; particularly, given that excise duties disproportionately impact the poor they shouldn't be additionally burdened with a VAT increase. We believe it is necessary to pursue a multi-prong strategy and considerations must be given as to whether these duties are the most effective and socially optimal way of dealing with alcoholism and smoking.[8]

Taxing luxury consumption is also an avenue to make the tax system more progressive. South Africa currently has a limited range of *ad valorem* excise duties on luxury goods paid by the manufacture or importer. These raise a limited, but not insignificant, amount of revenue – in 2017/2018 R3.8bn and projected to rise to R4.8bn in 2020/2021 (in nominal terms). However, they will maintain their share in the overall tax mix.

There is room to further tax luxury consumption through the increase and expansion of *ad valorem* excise duties and the institution of a higher VAT rate on luxury goods, a historic demand of civil society and the labour movement. A VAT on luxury goods (for example at 20%) could include those bought only by the rich, as well as upper segments of other goods

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[6] Monkam, Woolard, and Ajam, 69.

[7] World Health Organization, *WHO Report on the Global Tobacco Epidemic 2015: Raising Taxes on Tobacco* (World Health Organization, 2015); World Health Organization and the Secretariat of the WHO Framework Convention on Tobacco Control, 'The Economic and Health Benefits of Tobacco Taxation', accessed 26 February 2018, http://www.who.int/tobacco/publications/economics/post2015tobacco/en/.

[8] This does not imply that all submitting organisations support not increasing sin taxes. This was noted in particular by Equal Education

markets, for example, fancy cars, expensive fridges, and so on. Given the existing tax administration systems this can be feasibly implemented. It can also balance any cost incurred from expanding zero-rated items. Further, given that a higher share of luxury items are imported, this should not unduly dampen domestic demand and could modestly assist in closing the balance of payments. Access to luxury goods is an expression of inequality. The selection of items should not place goods that poorer households save for beyond their reach.

Recommendations

1. **Reject the increase in VAT, and look at options to make the VAT system less regressive**.
2. **Reduce the rate of increase for the fuel levy**.
3. **Investigate the setting of excise** duties in a manner that achieves social objectives but does not unduly tax the poor.
4. I**ncrease *ad valorem* excise duties on luxury goods** further than already proposed and expand the list of goods covered by these taxes.
5. **Institute a higher VAT on luxury goods** making the expanded zero-rating tax neutral.

3. VAT zero rating

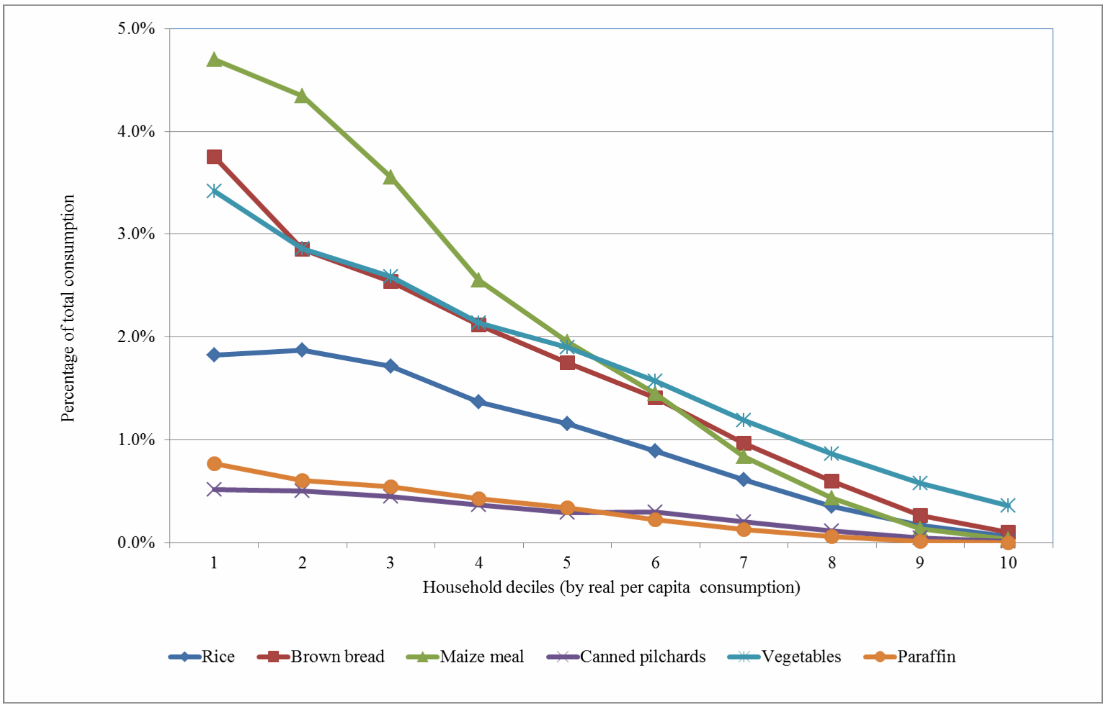
Minister Gigaba argued in his budget speech that the current zero-rating of 19 basic food items, such as maize meal, brown bread, dried beans and rice, will "limit the impact on the poorest households".[9] Unfortunately this is misleading.

The case for zero rating

It is widely recognised that zero-rating makes VAT less regressive,[10] the DTC notes: "the zero-rating of basic foodstuffs reduces the progressivity of VAT and mitigates the impact of VAT on the poor to some extent".[11] From the 2010/11 Income and Expenditure Survey we see that the poorest 70% of the population (all below the income tax threshold) derived 70% of the monetary benefit of zero-rating.[12] A number of zero-rated items effectively target the poorest as these products make up a larger share of their consumption baskets than for higher income earners. This is shown Figure 4 for a select number of zero-rated items where we see clearly that they are a more important component in the consumption baskets of lower-income households.

[9] Malusi Gigaba, 'Budget Speech 2018', 25 February 2018, 11, http://www.treasury.gov.za/documents/national%20budget/2018/speech/speech.pdf.
[10] Ada Jansen and Estian Calitz, 'Considering the Efficacy of Value-Added Tax Zero-Rating as pro-Poor Policy: The Case of South Africa', *Development Southern Africa* 34, no. 1 (2 January 2017): 56–73, https://doi.org/10.1080/0376835X.2016.1269635; Ada Jansen and Estian Calitz, 'How Effective Is VAT Zero Rating as a Pro-Poor Policy?', *Econ3x3*, 20 July 2015, http://www.econ3x3.org/article/how-effective-vat-zero-rating-pro-poor-policy; Dennis Davis and Ingrid Woolard, 'First Interim Report on VAT' (Davis Tax Committee, July 2015).
[11] Davis and Woolard, 'First Interim Report on VAT', 23.
[12] Jansen and Calitz, 'Considering the Efficacy of Value-Added Tax Zero-Rating as pro-Poor Policy'.

Figure 4 Share of total consumption of select zero-rated items by household income decile



Source: Jansen and Calitz (2017)

Despite this, various researchers have argued that zero-rating is a less redistributive measure than direct social transfers to the poor. This is correct and we support universal social security. However, politically speaking, National Treasury has provided limited increases to and proved ready to reduce, in real terms, or provided very limited increases to, social transfers. There is little reason to believe, therefore, that a removal of zero-rating, particularly in a period of austerity, would see a compensatory increase in direct social transfers, something which has not happened in this budget in response to the VAT increase. Further, zero-rating certainly targets the poor as well, if not better, than other forms of social spending, for example, on roads or water.

Will existing zero rating cushion the poor against the rise in VAT?

Although zero-rating generally positively contributes towards reducing inequality and poverty, it is not true that the *existing* zero-rating of 19 food items will cushion the most vulnerable from the proposed VAT increase. This is because:

1. **Zero-rated goods do not necessarily make up the majority of low-income households food consumption needs**. PACSA tracks a basket of goods consumed most commonly by the poor. In June 2015 only 45% of the rand value of this basket was zero-rated.

2. **The current basket of zero-rated goods is not, in all cases, optimally targeted**. For example, zero-rating on frozen vegetables and “basic” fresh vegetables benefits the

poor but zero-rating on more expensive fresh vegetables does not, while canned vegetables, consumed by the poor, are not zero-rated.[13]

3. **The current basket of zero-rated goods excludes a number of goods consumed heavily by the poor**, for example, white flour, canned beans, margarine, chicken, polony, candles, and soap.

4. **Food consumption patterns matter and food and fuel price rises can push low-income households *away* from zero-rated items**. PACSA shows that as food prices rise and households drop nutritious food from the plate, they substitute these with relatively cheaper fats, salts and sugars that are not zero-rated. Further, as some zero-rated items (like dry beans) have longer cooking times, a rise in fuel prices can shift consumption away from these.[14]

The increase in VAT will therefore, undoubtedly, result in a fall in the real disposable income of poor South African households, and there is considerable danger that this will increase poverty and inequality.

VAT zero rating in comparison

It is also worth pointing out that the cost to revenue collection of zero-rating is less than the cost of various tax breaks enjoyed almost exclusively by higher-income households. Table 1, from the 2018 Budget Review, shows that in 2015/16 total personal income tax relief from the listed items cost the state R58.3bn whereas the 19 zero-rated food items cost almost three times less at R22.8bn. The subsidy on zero-rated items was exceeded by subsidies to private retirement savings while medical aid tax breaks cost almost as much.

Table 1 Tax expenditure estimates PIT vs VAT

R million	2012/13	2013/14	2014/15	2015/16
Personal income tax				
Pension and retirement annuity contributions	26 314	28 467	30 485	31 772
Medical	20 272	21 883	19 750	20 442
Interest exemptions	2 067	2 191	2 418	2 592
Secondary rebate (65 years and older)	1 533	1 711	2 087	2 186
Tertiary rebate (75 years and older)	119	132	177	185
Donations	620	826	963	633
Capital gains tax (annual exclusion)	309	393	458	446
Total personal income tax	**51 233**	**55 603**	**56 338**	**58 256**
19 basic food items[7]	**18 628**	**20 107**	**21 503**	**22 793**

Source: National Treasury, Budget Review 2018

[13] Ada Jansen, Elizabeth Stoltz, and Derek Yu, 'Improving the Targeting of Zero-Rated Basic Foodstuffs under Value Added Tax (VAT) in South Africa - An Exploratory Analysis', Working Papers (Stellenbosch University, Department of Economics, 2012), https://ideas.repec.org/p/sza/wpaper/wpapers159.html.

[14] PACSA, 'Davis Tax Committee May Have Underestimated Exposure to Levels of Working Class Household to VAT on Food', PACSA Food Price Baraometer (Pietermaritzburg Agency for Community Social Action, June 2015).

Recommendations

1. **Expand zero-rating** to include more items commonly consumed by low-income groups, with particular attention to the needs of women, such as sanitary pads, and children.
2. **Review existing zero-rated items** to assess how they can be optimally targeted.
3. **Reduce tax breaks that predominately benefit higher-income households** (such as on pensions and medical aid).

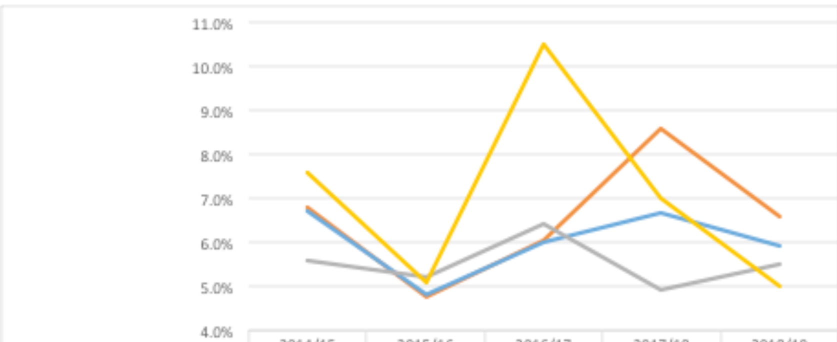
4. The impact of increases to indirect taxes in context

The rise in indirect taxes must be viewed in a broader context, a few aspects of which are considered here.

Social grants

Limited increases or declines in the real value of social grants, on which the lowest-income households rely, limit disposable income. Figure 5 shows that over the last five years the old age pension and child support grant have risen below CPI inflation twice each, and below food price inflation on all but one occasion for the old age pension and two occasions for the child support grant. Table 2 shows the real annual increase in social grants compared to the real rise in the fuel levy: the latter outstrips the increase to social grants by large margins in all but one instance (the same is true for excises taxes). It is also worthwhile to note, that the value of these grants, as a share of different poverty lines, has fallen. In 2011/12, the child support grant would have covered 79% of the cost of basic foodstuffs necessary to avoid hunger. By 2018/19 it covered only 71% of the cost of these goods. Similarly, the value of the old age pension grant, had been declining relative to the upper-bound poverty line until last year.

Figure 5 Nominal annual percentage change in grants compared to CPI and food inflation, 2014/15 - 2018/19



	2014/15	2015/16	2016/17	2017/18	2018/19
Child Support Grant	6.8%	4.8%	6.1%	8.6%	6.6%
Old Age Pension Grant	6.7%	4.8%	6.0%	6.7%	5.9%
CPI inflation	5.6%	5.2%	6.4%	4.9%	5.5%
Food price inflation	7.6%	5.1%	10.5%	7.0%	5.0%

Source: SPII (2017); National Treasury; Budget Review 2018, Table 5.9

Table 2 Real annual change in grants vs real annual change in indirect tax rates

	Old Age Pension Grant	Child Support Grant	Fuel levy (petrol, diesel average)
2010/11	0.6%	-2.0%	5.7%
2011/12	1.3%	1.7%	2.0%
2012/13	0.4%	0.8%	6.7%
2013/14	-0.2%	-0.2%	2.2%
2014/15	0.9%	0.9%	0.1%
2015/16	-0.7%	-0.8%	8.0%
2016/17	0.8%	0.8%	6.6%
2017/18	0.3%	2.0%	4.2%
2018/19	1.0%	1.6%	2.2%

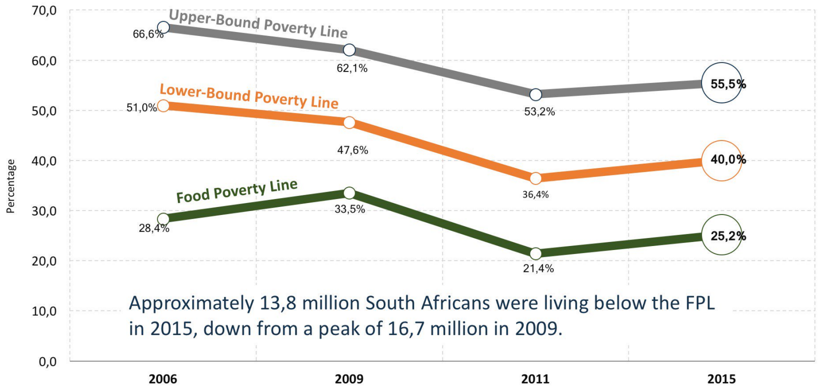
Source: National Treasury, Budget Review 2018; SARB, Tax Chronology of South Africa 1979-2016; SPII (2017)

It is clear therefore that the limited rise in social grants will not compensate for the increase in the VAT rate, excise duties and the fuel levy.

Poverty, wages and employment

The current rise in poverty rates is also an important context to consider. This is shown in Figure 6 where we see an increase in all three measures from 2011 to 2015. Poverty is particular acute for young, with 61% of children (age 0-17) living in poverty in 2015!

Figure 6 Poverty headcount by different poverty lines (2006 - 2015)



Source: StatsSA, 2017

Low wage growth for the majority of workers and high levels of unemployment are also critical factors in stressing limitations on the disposable income of low-income households that will be faced with considerable tax increases. National Treasury has noted lower wage growth as a reason for low PIT collection and the need to increase VAT. There is a danger of being caught in a vicious cycle whereby this reasoning prompts the introduction of regressive tax measures that further increase inequality and curtail economic growth thus exacerbating the original problem.

We have noted social grants above as they play a vital role for low-income households but we must not forget that the majority of the adult population does not receive any form of social assistance.

State spending

The increase in VAT will also raise costs for government. The government spends approximately R500bn on procurement of goods and services. If all of these incur VAT then the one percentage point increase will incur approximately R4.4 billion in extra cost, although the figure is likely somewhat lower, when VAT exempt goods and services are considered.

Recommendations

1. **Reject VAT increase** and **moderate increases to excise duties and the fuel levy**.
2. **Insist on larger increases to social grants**.

5. Personal income tax

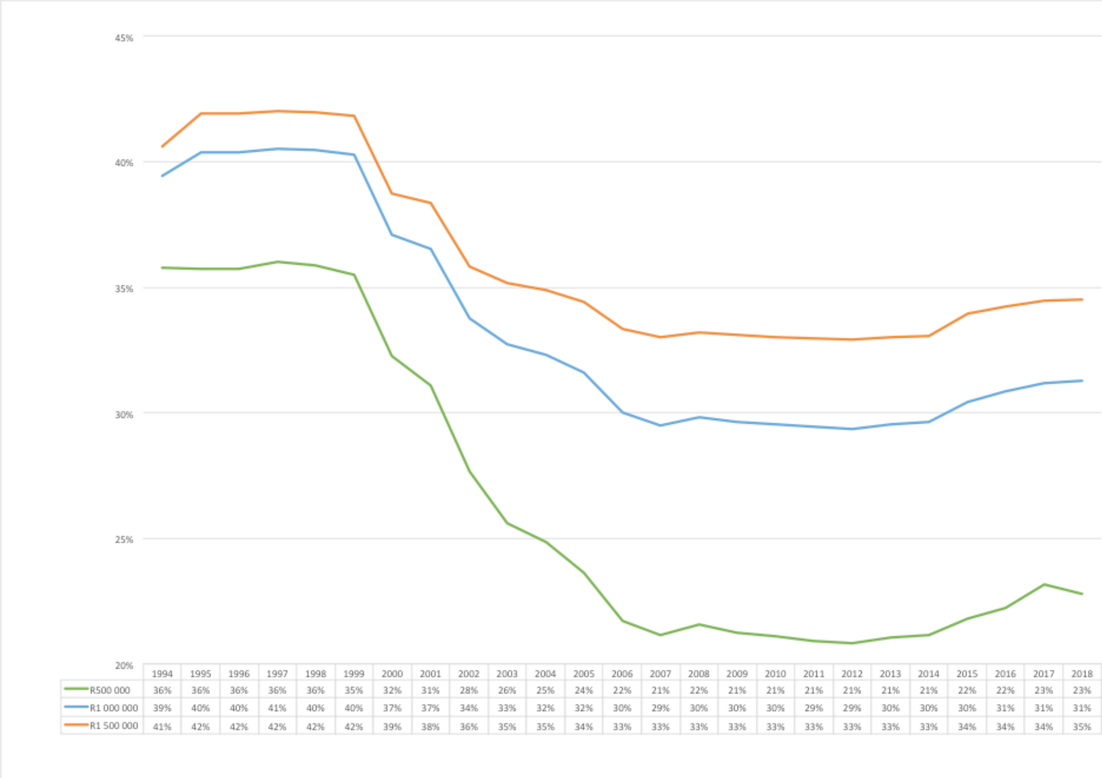
"The South African PIT system is progressive but does little to reduce overall income inequality." – Davis Tax Committee[15]

PIT in South Africa is considered "mildy progressive"[16]. However, a number of important trends are worth noting, all which support the proposition that it is possible to increase PIT rates.

PIT rates have fallen considerably over the last three decades. Figure 7 shows the effective tax rate faced by those earning R500,000, R1mn, R1.5mn (in 2018 rands) between 1994 and 2018.[17] As we can see these have fallen dramatically, particularly between 1999 and 2007. Between 2007 and 2014 they remained largely flat after which they begin to rise modestly. Somewhat perversely, the largest percentage increase has been for those earning R500 000 despite the introduction of the new 45% tax break at the upper end.

[15] Monkam, Woolard, and Ajam, 'Macro Analysis of the Tax System and Inclusive Growth in South Africa', 26.
[16] Ingrid Woolard et al., 'How Much Is Inequality Reduced by Progressive Taxation and Government Spending?', *Econ3x3*, October 2015.
[17] This was calculated by deflating the 2018 rand value for each prior year by the CPI index and then using the tax brackets and formula given in the annual Budget Reviews to calculate the tax payable on the deflated amount.

Figure 7 Effective tax rates (accounting for rebates) for those earning the equivalent of R500 000, R1mn and R1.5mn in 2018



Source: SARB, Tax Chronology of South Africa 1979-2016

To put this into monetary terms:

- A tax payer earning R1.5mn today pays R110,000 less tax than she would in 1999.
- A tax payer earning R1mn today pays R90,000 less tax than she would in 1999.
- A tax payer earning R500,000 today pays R64,000 less tax she would in 1999.

Tax breaks for higher-income individuals have accompanied a fall in PIT rates. For example, Table 3 shows the cost to the fiscus of tax breaks associated with pensions, medical aid, interest income, retirement, and capital gains. Recall that only the top 30% pay any PIT and thus enjoy these breaks, and that many low-income workers have no form of medical aid or retirement funds, let alone tax-exempt investments.

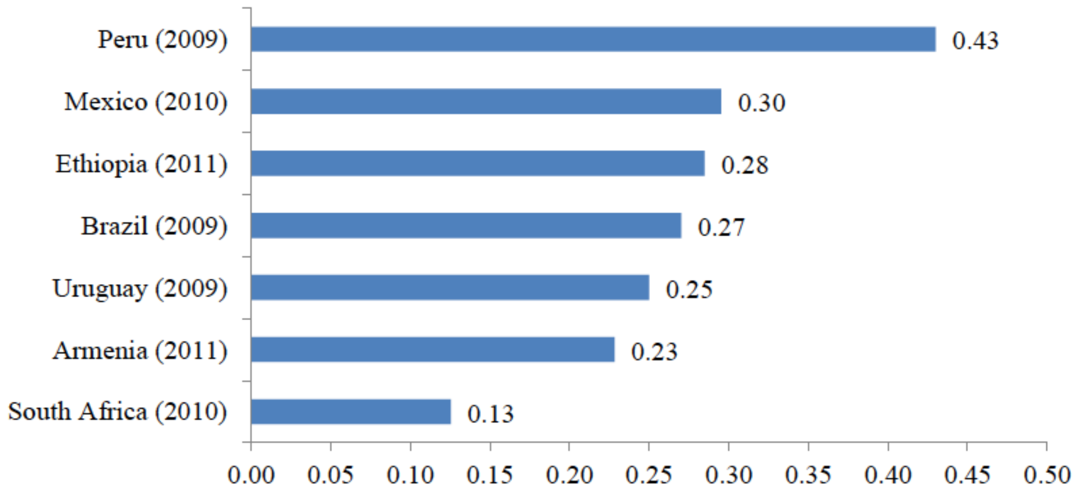
Table 3 Tax expenditure on PIT tax breaks

R million	**2012/13**	**2013/14**	**2014/15**	**2015/16**
Personal income tax				
Pension and retirement annuity contributions	26 314	28 467	30 485	31 772
Medical	20 272	21 883	19 750	20 442
Interest exemptions	2 067	2 191	2 418	2 592
Secondary rebate (65 years and older)	1 533	1 711	2 087	2 186
Tertiary rebate (75 years and older)	119	132	177	185
Donations	620	826	963	633
Capital gains tax (annual exclusion)	309	393	458	446
Total personal income tax	**51 233**	**55 603**	**56 338**	**58 256**

Source: National Treasury, Budget Review 2018

PIT in South Africa is less progressive than in other comparable countries as highlighted by Inchaste et al. (2015) in their World Bank paper, and shown in Figure 8.

Figure 8 Progressivity of direct taxation systems: the Kakwani coefficient



Source: Inchaste et al. (2015), p. 17

The rich have contributed a declining share to tax revenue in comparison with their share of taxable income. Between 2007 and 2016 the taxable income of those earning over R1mn grew by 313% (in nominal terms) but their contribution to tax assessed grew by only 302%, showing that their share in taxable income grew by more than the share of tax assessed.

While PIT rates have fallen globally over this period there has been some reversal in this trend. Notes the OECD: "Since the onset of the crisis, more than half of the OECD countries have increased personal income taxes on capital (e.g. France, Portugal, Spain, and the US) while others are reducing ceilings for tax privileged savings (e.g. Ireland, the UK)." Personal tax rates on dividends, interest and gains have also increased in a number of countries since the economic downturn.[18]

Recommendations

There is clearly room to increase PIT. Table 4 divides PIT payers into five income groups and compares the proposals in the 2018 Budget Review (Table 4.6) with two alternative scenarios. The table shows the effective tax rates for the five brackets and then potential alternatives to that.

In Scenario 1, the lower three effective tax rates are left as is and the effective tax rate for those earning between R500,000 and R1mn is raised from 26% to 28% and the effective rate for those earning over R1mn is raised from 37% to 40%. In this Scenario 2, the top three rates are raised from 16.7% to 18%, 26% to 29%, and 37% to 41%. Scenario 1 raises an additional R27.2bn and Scenario 2 an addition R47.4bn. These are then adjusted downwards

[18] Michael Förster, Ana Llena-Nozal, and Vahé Nafilyan, 'Trends in Top Incomes and Their Taxation in OECD Countries', 15 May 2014, https://doi.org/10.1787/5jz43jhlz87f-en.

to take account of an assumed elasticity of taxable income (ETI) of 35% – essentially an adjustment based on the assumption that those taxed more might adjust their income sources or evade tax by this margin. With this adjustment the two scenarios still raise an additional R17.7bn and R30.8bn.

Table 4 Potential extra PIT revenue raising

(R bn)	Proposed 2018/2019			Scenario 1		Scenario 2	
	Taxable income	**Effective tax rate**	**Tax accessed**	**Effective tax rate**	**Tax accessed**	**Effective tax rate**	**Tax accessed**
0 - 150 000	432.2	2.4%	10.2	2.4%	10.2	2.4%	10.2
150 001 - 250 000	351.8	9.4%	33.2	9.4%	33.2	9.4%	33.2
250 001 - 500 000	736.7	16.7%	123.2	16.7%	123.2	18.0%	132.6
500 001 - 1 000 000	549.0	26.0%	142.5	28.0%	153.7	29.0%	159.2
1 000 000 +	531.7	37.0%	196.7	40.0%	212.7	41.0%	218.0
Total:	**2601.5**		**505.8**		**533.1**		**553.3**
Additional revenue					**27.2**		**47.4**
Additional revenue adjusted for ETI of 35%:					**17.7**		**30.8**

Source: National Treasury, Budget Review 2018

It is worth noting that this is not a concrete fully-costed proposal (and not necessarily one advocated for by every organisation supporting this submission). However, it shows that with relatively modest increases (more significant for those earning above R1mn) substantial additional tax revenue can be raised, which would avoid the necessity for a VAT increase.

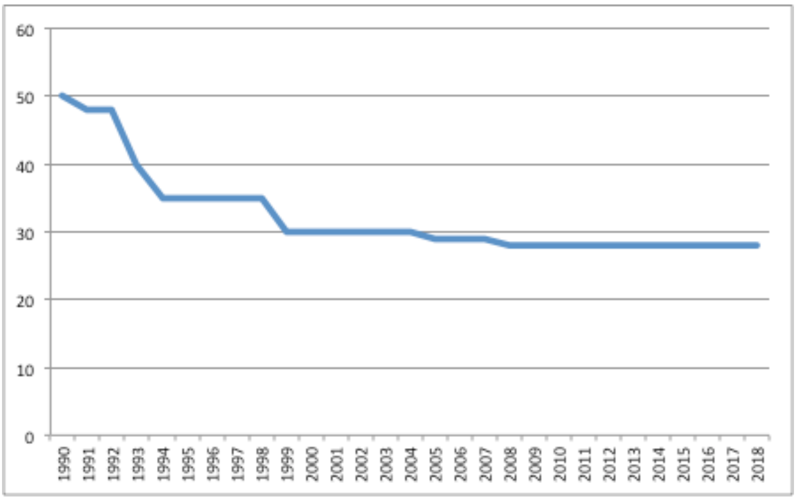
6. Corporate income tax

A number of trends in CIT indicate room to raise revenue through lifting the CIT rate.

CIT rates have seen a significant decrease in South Africa over the last three decades. Figure 9 shows the CIT rate falling from 50% in 1990 to 28% in 2008 where it has remained. The effective CIT rate differs by sector[19] but the trend is the same.

[19] Monkam, Woolard, and Ajam, 'Macro Analysis of the Tax System and Inclusive Growth in South Africa'.

Figure 9 Corporate income tax rates in South Africa (1990 - 2018)



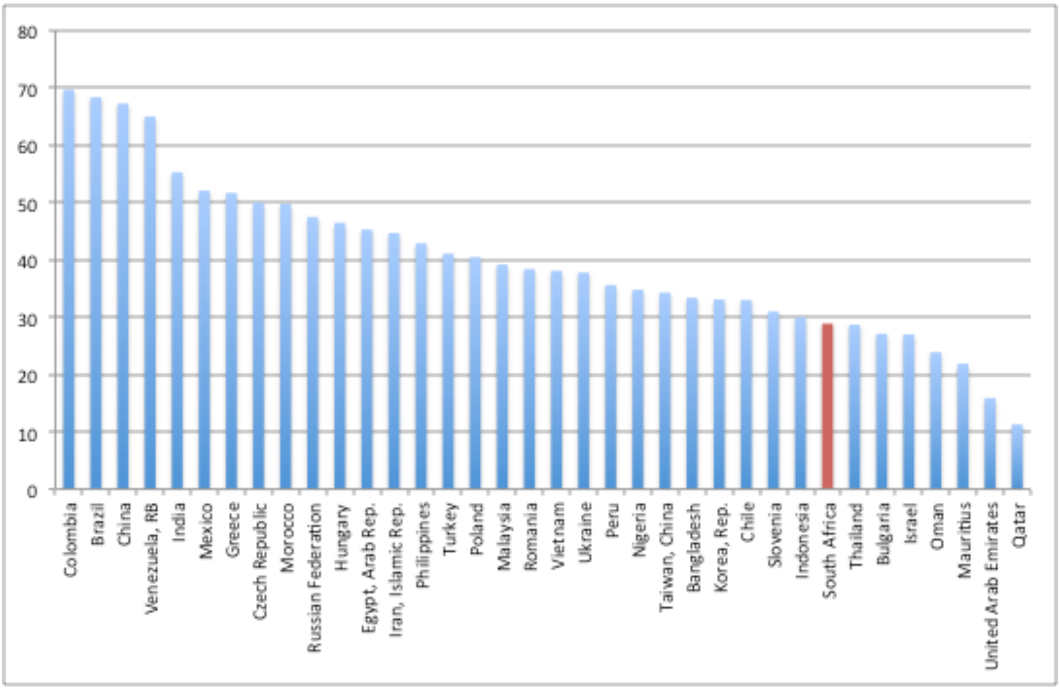
Source: SARB, Tax Chronology of South Africa 1979-2016

The share of CIT revenue in the tax mix has fallen over the last decade and will continue to fall under the current tax proposal. Figure 3 shows a fall from a high of 26.7% in 2008/2009 to 17.9% in 2017/2018, projected to fall further to 16.7% by 2020/2021. This differs markedly from OECD norms[20] where CIT has represented a rising share.[21]

Contrary to what the Finance Minister asserted, the overall tax responsibility of South African firms is low by international standards. The best measure for this is the World Bank and PwC *Paying Taxes* measure as part of the *Doing Business* dataset. This takes account of all taxes facing companies, not just CIT, and shows this as a percentage of profits for an average middle-sized firm. South Africa ranks 172 out of 213 countries, where 1 has the highest company tax and 213 the lowest. South Africa has the first lowest tax rate in Africa and is in the bottom quarter of emerging markets, as shown in Figure 10.

[20] Monkam, Woolard, and Ajam, 69.
[21] Caveats must be noted: this is partly because of declining PIT rates and increase sales tax rates in OECD countries.

Figure 10 Total tax and contribution rate (% of profit) of companies in emerging markets



Note: Shows taxes and mandatory contributions that a medium-size company must pay or withhold in a given year.
Source: World Bank, Doing Business 2017 index
http://www.doingbusiness.org/data/exploretopics/paying-taxes

It is also important to restate that there is little evidence that lowering CIT boosted economic growth in South Africa. Further, considerable evidence exists internationally that lowering CIT can increase inequality, which is detrimental to growth and social outcomes.

Recommendations

There is clearly room to raise CIT. CIT will contribute an expected R231bn to the 2018/2019 tax revenue in the current proposal. The overall effective CIT rate is approximately 28% according to SARS Tax Statistics 2017

Table 5 shows four alternative scenarios with effective rates ranging from 30% to 35%. As shown, even a 2 percentage point increase can raise an additional R16.5bn. The table also shows how much extra revenue could be raised if we assume the taxable income falls by 5% due to the increased CIT rate (i.e. if a degree of offsetting occurs). Even with this profit fall, additional revenue of between R4.1bn and R43.4 can be raised.

Table 5 CIT 2018/2019 budget proposal vs alternate scenarios

	Taxable income	Effective tax rate	CIT raised	Difference between budget proposal and scenario	CIT raised with 5% profit loss	Difference between budget proposal and scenario with 5% profit loss
Budget proposal	825.8	28%	231.2			
Scenario 1	825.8	30%	247.7	16.5	235.3476043	4.1
Scenario 2	825.8	32%	264.2	33.0	251.0374446	19.8
Scenario 3	825.8	35%	289.0	57.8	274.5722051	43.4

Once again we should note that this is not a concrete fully-costed proposal (and not necessarily one advocated for by every organisation supporting this submission). However, it shows that substantial additional tax revenue can be raised from increasing CIT which would mitigate the need to raise VAT.

7. Property and capital gains taxes

Given the very high levels of wealth inequality it is problematic that taxes on property account for a very small share of the South African tax mix. As shown in Figure 3, taxes on property – including donations tax, estate duty (inheritance tax), securities transfer tax (STT), and transfer duties – rose to 2.7% of the tax mix in 2005/2006 but then fell to 1.3% in 2017/2018 where they are projected to remain. Capital gains tax (CGT – formally a form of income tax but considered here as it is a tax accrued from owning property) has also fallen from a share of tax revenue in 2007/2008 of 3.6% to 2.4% in 2017/2018. In rand terms, the rate at which property and capital gains taxes have increased is below the rate of increase on other major tax forms.

While these trends reflect poor economic growth they also reflect the tax structure.

- **CGT**, for example, raised only R17billion in 2016/17, a mere 1.5% of tax revenue. Because not all capital gains are taxed, in 2017, individuals only paid a rate of 16% on capital gains, and companies 22%.[22] This is below the OECD and BRICS norm.
- Tax on inheritance – **estate duty** – is levied at only 20% and raises revenue worth 0.05% of GDP compared with the OECD average of 0.2%.[23]
- Bonds are excluded from **securities transaction tax** (STT) (a tax on sale of shares) and there is no transaction tax on derivatives and other forms of financial transactions. Despite South Africa's market capitalist to GDP ratio being almost triple the OECD average, revenue from STT lags behind the OECD average.
- South Africa has no annual "**net wealth tax**" that would tax the total value of wealth held in a given year.

[22] SARS, 'Capital Gains Tax (CGT)', accessed 20 February 2018, http://www.sars.gov.za/Tax-Rates/Income-Tax/Pages/Capital-Gains-Tax-(CGT).aspx.

[23] SACTWU and COSATU, 'Submission to the Davis Tax Committee on Possible Wealth Taxation in South Africa', June 2017.

Recommendations

Considering that large amounts of wealth were accumulated under apartheid, that this wealth is passed between generations, and that black earners have less assets to begin with and must support a higher number of dependents, these low taxes on wealth are indefensible and perpetuate inequality.

Some possible approaches include:

- Institute a permanent net wealth tax in the international range of 05%-2.5%.
- Raise the CGT inclusion rate to 100% (so all capital gains are taxed) and the tax rate to comparative rates to PIT.
- Raise the STT rate and broaden applicability to include bond markets. Investigate the best modalities of a universal financial transactions tax (FTT).
- Institute a land property tax, particularly on vacate land, and a property rate or transfer duty surcharge for second and foreign owned homes.
- Significantly raise the estate duty tax and close loopholes.

8. Which taxes are better?

The Budget Review makes the unsubstantiated assertion that an increase to VAT has been estimated to "have the least detrimental effects on economic growth and employment over the medium term".[24]

The use of "least detrimental" is revealing in that it implies that all tax increases, by their very nature, have detrimental impacts. Indeed, if you apply the theoretical framework and statistical models that presumably underpin this claim, this will be the case, always and by design.[25] The theoretical basis and model are "supply side" dominated. This means that changes in (relative) prices control the outcomes. Increases in CIT and VAT will be passed on almost entirely to consumers in the form of higher prices leading to a fall in spending in the economy and a decline in investment and growth rates; increasing PIT will have the same effect

The model pays little attention to how a) extra tax revenue can boost spending, b) extra spending can lead to improved social outcomes (like less poverty) which can be beneficial to growth, c) increased taxation on CIT and PIT can reduce inequality.[26] Essentially the

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[24] National Treasury, 'Budget Review 2018' (Government of the Republic of South Africa, 21 February 2018), 38, http://www.treasury.gov.za/documents/national%20budget/2015/review/FullReview.pdf.

[25] The National Treasury presumably uses their computable general equilibrium SAGE model based on the Standard Computable General Equilibrium Model developed by Löfgren et al. (2002) adapted for South Africa by Thurlow and van Seventer (2002) and further 'extended' in Thurlow (2004) and Arndt et al. (2011), making use of neoclassical closures. This approach, with very little substantiation, is also used in the Davis Tax Commission's Macroeconomic Report. A worthwhile response to that is found in SACTWU (2015).

[26] The IMF also notes that the "conventional belief that taxing income entails a higher welfare (efficiency) cost than taxing consumption is based in part on the fact that income tax, which contains elements of both a labor tax and a capital tax, reduces the taxpayer's ability to save. Doubt has been cast on this belief, however, by considerations of the crucial role of the length of the taxpayer's planning horizon and the cost of human and

model assumes that roads build themselves, malnutrition has no negative spillovers, unequal access to opportunity does not reduce the supply of skills and entrepreneurs in the economy, and inequality makes no appreciable mark on the profit rate and investment via the level and/or composition of aggregate demand.

By largely ignoring the distributional consequences of taxation (i.e. the impact on the distribution of income, and hence inequality) **the theoretical approach and model fail to consider that**:

- **An increase to CIT is distributed between shareholders, consumers and labour and that this will shape economic outcomes**.

- **Increasing PIT can reduce inequality and decreasing PIT exacerbate inequality.** Evidence from the OECD shows how a reduction in top marginal tax rates raises the pre-tax shares of top incomes across OECD countries.[27] Similarly, "Atkinson and Leigh (2010) found that a 1 percent decrease in the median tax rate on capital income paid by the top percentile is associated with a 1.5 percent rise in the income share of the top percentile group".[28]

- **Shifting income from the rich to the poor (or state spending) can spur greater spending and growth**. Using "representative households" the model does not take account of the consequences of shifts in the functional distribution of income and therefore has no room for the stimulating impacts associated with shifting money to public spending or the poor.

- **Reducing inequality is beneficial for economic growth**, a now established fact. Instead, the theoretical frameworks posit a trade-off between equity and growth. The importance of this with regards to taxation is noted by the OECD: [29]

  "Another rationale for higher top marginal tax rates is that, under some circumstances, large income inequality may harm long-run economic efficiency, making the traditional trade-off between equity and efficiency less relevant. Very large income inequality may generate inequality traps (Bourguignon et al., 2007), resulting into weaker equality of opportunity for the next generation and consequently lessening future overall economic efficiency. Reducing income inequality may therefore improve long-run economic efficiency. Furthermore, if top wage executives' pay exceeds their marginal productivity, then high tax rates may

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physical capital accumulation. The upshot of these theoretical considerations renders the relative welfare costs of the two taxes (income and consumption) uncertain." Vito Tanzi and Howell H. Zee, *Tax Policy for Developing Countries* (International Monetary Fund, 2001).

[27] See also Hungerford, Thomas. 2012. *Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945.* Congressional Research Service. http://graphics8.nytimes.com/news/business/0915taxesandeconomy.pdf See also: Hungerford, Thomas. 2011. *Changes in the Distribution of Income Among Tax Filers Between 1996 and 2006: The Role of Labor Income, Capital Income, and Tax Policy*. Congressional Research Service. http://taxprof.typepad.com/files/crs-2.pdf and Hungerford, Thomas. 2013. *Changes in Income Inequality Among U.S. Tax Filers Between 1991 and 2006: The Role of Wages, Capital Income, and Taxes.* http://ssrn.com/abstract=2207372

[28] Förster, Llena-Nozal, and Nafilyan, 'Trends in Top Incomes and Their Taxation in OECD Countries'.

[29] Förster, Llena-Nozal, and Nafilyan.

prevent rent-seeking behaviour and thereby improve both equity and efficiency (Piketty et al., 2011)."

The National Treasury, therefore, does not seem to have taken seriously that raising taxes that predominantly impact companies and higher-income earners can both reduce inequality and spur growth. The OECD's chief economist in 2013, Pier Carlo Padoan, for example, noted:[30]

> "Tax hikes that can bolster equality and have relatively little impact on long-term growth, such as on real estate, should be considered.... Meanwhile, hikes in capital income taxes would be positive for equity and would not necessarily distort growth, while shifting tax burdens away from labour and towards green consumption taxes, for instance, would also bring benefits."

The negative impact of VAT – in that it can worsen poverty and inequality, and thus harm aggregate demand in the economy, social outcomes and growth – is therefore underestimated. This is particularly important in South Africa that has extreme levels of inequality and should be using every instrument at its disposable to reduce these.

A number of other points must be noted:

- **We are unaware of robust evidence in South Africa that indicates that the dramatic falls in PIT and CIT have had a growth enhancing effect on the local economy**.

- **Arguments that income tax rates must be kept low to maintain international competitiveness risk a "race to the bottom"** scenario where every country does all they can to appease business interests until we are left with ultra-low wages and ultra-low taxes. Other measures must be instituted to ensure South Africa raises levels of investment in the economy.

- **It is possible that increases to PIT and CIT are less inflationary** than increases to VAT.[31]

The argument that VAT is the "least harmful" tax to raise is, therefore, unsubstantiated, resting on a limited theoretical approach and inappropriate statistical modelling.

Recommendations

1. **Require National Treasury to make available, in full, the evidence** upon which the claims that a) raising direct taxes is harmful to economic growth, b) raising indirect taxes in particular VAT, is least harmful to growth, and has limited impact on the poor, are based, including the assumptions and models that underpin this.

[30] Pier Carlo Padoan, 'How to Get It Right: Government Balances, Growth and Income Inequality', *OECD* (blog), 2013, http://www.oecd.org/forum/government-balances-growth-and-income-inequality.htm.
[31] Davis and Woolard, 'First Interim Report on VAT', 10.

9. The broader framework

The tax proposals in the 2018 Budget are made in the context of a wider fiscal framework. This includes targets for borrowing and spending.

We are extremely concerned by the sharp cuts to social spending on programmes vitally important to poverty and inequality reduction, job creation and growth. For instance, the baseline funding available for basic education and health care has been cut. Such decisions will have negative social outcomes and restrain economic growth.

This calls for a reconsideration of the fiscal resources necessary to maintain vital social spending, reduce poverty and inequality, and spur job creation and growth. Only after this should appropriate levels of taxes and debt management be adopted. In this context we question whether the budget selects an appropriate tax-to-GDP ratio and whether the pace of debt reduction is appropriate. Detailed research regarding South Africa's debt and rating downgrades, and international comparisons, show that South Africa's debt-to-GDP ratio and yearly deficit is not unduly high by internationals standards and that while this cannot go on rising forever, speedy and severe contractions in borrowing can reduce economic growth (actually exacerbating debt levels in the medium term).

10. Conclusion

The purpose of a progressive tax and redistributive policy is to enable the government to rectify South Africa's legacy of inequality and injustice and fulfil the promise of a better life for all. This is an urgent task recognised, among others, in Section 9 of the Bill of Rights. The national budget is a critical instrument in achieving this. Any change to the tax regime must be one which reduces inequality and does not place additional burdens on the poor, while ensuring that government raises sufficient revenue to deliver on its constitutional obligations. We are very concerned that the taxation measures proposed in this budget take us away from those objectives. We have demonstrated here why that is the case and shown practically that viable alternatives exist. In the interest of equity, ensuring a decent standard of living for all, and achieving sustainable and inclusive development, we call upon Parliament to reject the regressive taxation measures proposed in this budget.