Standing Committee on Finance
Parliament of the Republic of South Africa
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Cape Town
South Africa

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28 February 2017

Chair, Members,

Budget 2017 Fiscal Framework and Revenue Proposals – Preliminary Comment

1. We present herewith our initial commentary on the fiscal framework and revenue proposals included in the 2017 Budget Review.

A. Fiscal framework

2. As a country, South Africa currently faces one of its most testing challenges given the weak economic growth, high unemployment and inequality, stubborn budget deficit, growing debt levels and spending pressures. At the same time, the country is fast running out of space for further tax increases to fund its expenditure demands and the reduction of the deficit.

3. While fiscal consolidation continues and the budget deficit is decreasing over time, this downward trajectory has slowed substantially having been reduced from 4.1% of GDP in 2010/11 to a forecast 3.4% in 2016/17. Crucially, the reduction of the budget deficit to below the benchmark 3% of GDP has once again been pushed out by another year to 2018/19 after initially having been forecast to fall below this level in 2016/17.

4. This slight slippage can primarily be attributed to underperformance in revenue collections due to lower than forecast GDP growth, with the expenditure ceilings having been stuck to. This slippage comes despite substantial tax increases amounting to R63 billion having been introduced over the course of the last three budgets.

5. However, we must emphasise that South Africa's deficit problem is not a revenue problem, but rather an expenditure problem. Since 2007/8 consolidated expenditure has ballooned from 27.2% of GDP to 33.4% of GDP in 2015/16. By 2015/16, consolidated tax revenues net of SACU payments had recovered to 2007/8 levels and are forecast to

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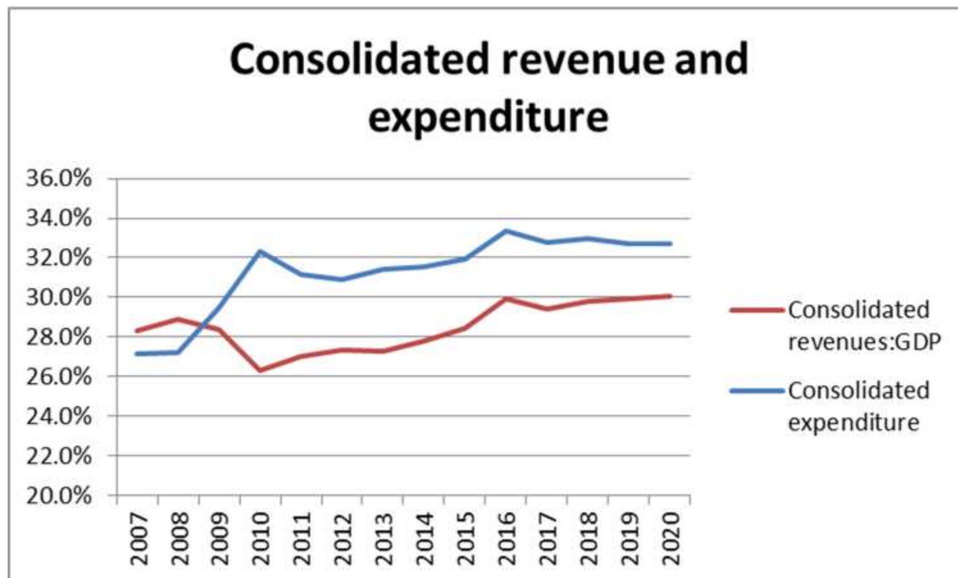
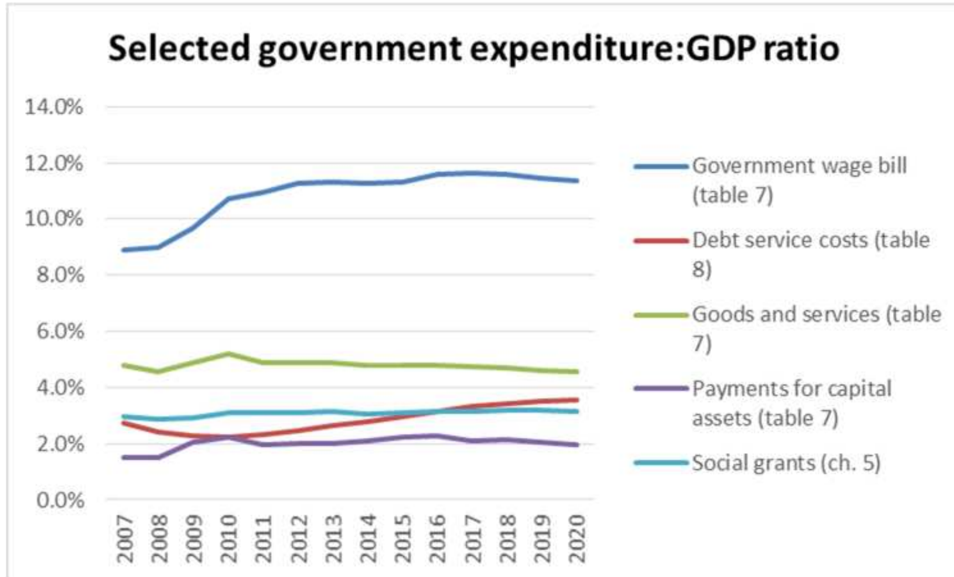
continue to grow to reach 27.5% of GDP in 2019/20. As a result, the level of taxation is now at record levels.

6. This problem is illustrated in the below graph which shows how expenditure growth has outstripped tax revenue growth. While expenditure as a proportion of GDP is forecast to fall slightly over the next three years, it is readily apparent that expenditure as a proportion of GDP needs to fall substantially over the longer term, particularly if space is to be created for new initiatives contemplated in the National Development Plan, such as the introduction of National Health Insurance, or increases in the funding of tertiary education.



7. While the expenditure reductions of R45 billion as part of the consolidation measures between 2015/16 and 2017/18 are to be welcomed, these are insufficient to make a significant dent in the level of spending. More needs to be done to improve the effectiveness and efficiency of government spending and to further lower the expenditure ceiling.

8. It is important to note that the majority of the expenditure problem lies with the government wage bill which has increased from 9% of GDP in 2007/8 to 11.6% of GDP currently. Most other items of expenditure (with the obvious exception of debt service costs) have remained relatively stable over this period. This is illustrated in the below graph.



9. It is in this light that we welcome the announcement that Government is working to reduce the head count, including considering voluntary severance packages. It is also crucial that wage agreement to be negotiated during the course of 2017 take into account the fiscal constraints and the substantial real increases granted in recent years.

B. Revenue proposals

10. We set out below our comments on the revenue proposals.

Tax increases and tax structure

11. As was noted in the 2016 Medium Term Budget Policy Statement, tax increases of R28 billion for 2017/18 were announced in the Budget. We note that the further additional tax measures of R15 billion for 2018/19 announced in the 2016 Budget remain on the table. We further note, with some concern, that further tax increases of R16.3 billion for 2019/20 have also been pencilled in.

12. We discuss below the manner in which the 2017/18 tax increases are proposed to be introduced.

13. No detail is provided on the make-up of the proposed R15 billion and R16.3 billion tax increases in 2018/19 and 2019/20 respectively.

14. While the Budget indicates that the tax increases for 2017/18 amount to R28 billion, in truth they are likely to be somewhat higher than this. This is because a number of tax proposals and changes have not been taken into account.

    - With effect from 1 March 2017, donations tax is to be levied on interest-free loans to trusts. While we have no empirical data on which to estimate the tax revenues that are likely to be raised from this initiative, anecdotal evidence suggests that at least R1

billion should be raised from this mechanism. This has not been taken into account in the revenue forecasts.

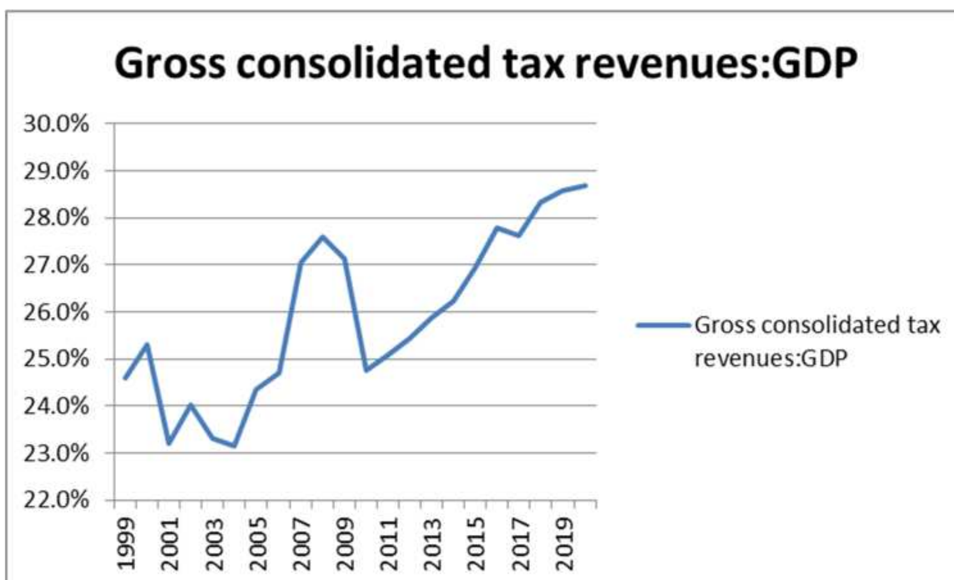
- The proposed sugar tax which is due to be implemented during the course of 2017/18 has not been taken into account in the tax increases. While it is not clear what revenues are expected to be generated from this tax, these could amount to in the region of R2 billion.

Level of taxation

15. It is important to bear in mind that the level of taxation in South Africa has been steadily growing since 2003/4 when the consolidated tax revenues after SACU payments stood at 22.4% of GDP. It reached a peak of 26.4% in 2007/8 before falling substantially in the wake of the global financial crisis. However, tax revenues have since recovered to similar levels with the level of taxation estimated to be 26.7% of GDP for 2016/17, increasing further to 27.5% by 2019/20. The below graph illustrates the level of taxation from 1998/99 to 2019/20.

16. For this graph we have used consolidated tax revenues before SACU payments as a better indication of the tax burden borne by South African taxpayers, given substantial subsidisation of the other SACU member countries by South Africa through the revenue-sharing formula.

17. This graph illustrates the strong upward trajectory of the tax burden which reaches 28.7% of GDP in 2019/20. This constant increase in the tax burden is unsustainable in the long term. If this does not stabilise, it is likely to crowd at space for any further tax increases in order to fund such initiatives as the NHI and comprehensive social security reform.



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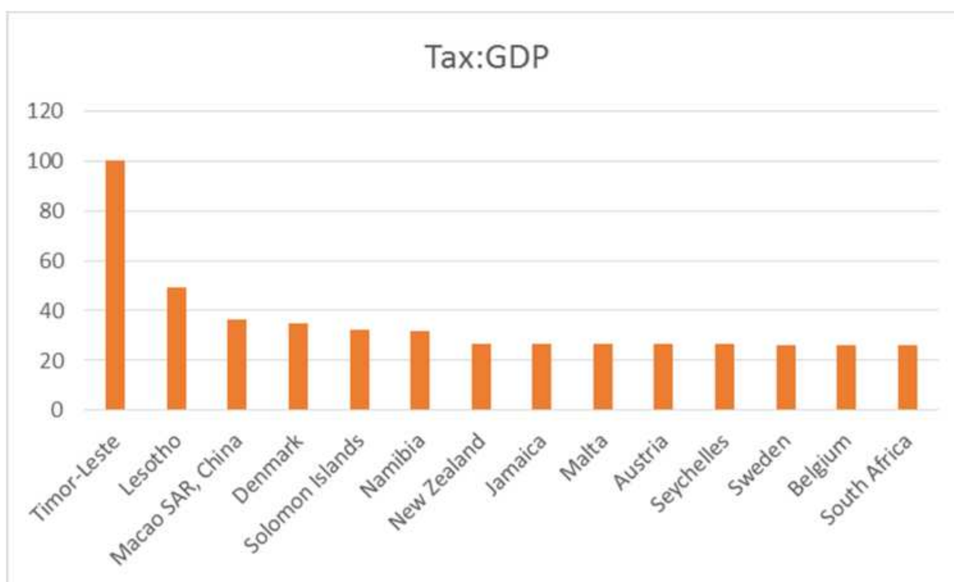
18. Of concern is that, according to World Bank Group data, South Africa had the fourteenth highest tax:GDP ratio (excluding social security contributions) of all countries that have reported data for 2013 (in fact South Africa would rank twelfth if Lesotho and Namibia, whose tax revenues consists substantially of SACU revenues derived from South Africa, was excluded and even higher if other exceptional jurisdictions such as Timore-Leste and Macao are excluded). South Africa's tax:GDP ratio is significantly higher than the world and Africa averages as well as that for middle-income countries. The below graph illustrates the countries with the highest tax:GDP ratios.



19. It is clear that South Africa has a high tax burden by international standards. While some of this tax burden is explained by a large social security system funded out of general tax revenues rather than social security taxes, if the tax burden was reduced by social security expenditure, South Africa would still have a relatively high tax burden.

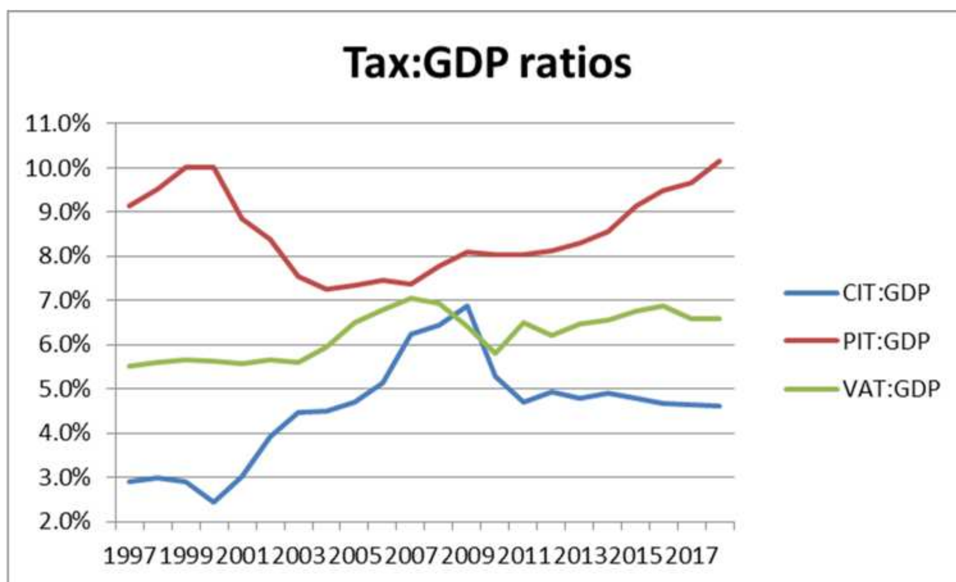
20. It is acknowledged that South Africa's high income and wealth inequality necessitates its fiscal policy to play a crucial role in reducing inequality and South Africa does extremely well in this regard with the largest reduction in inequality achieved by any of the countries studied to date by the World Bank according to its South Africa Economic Update Fiscal Policy and Redistribution in an Unequal Society published in November 2014. In this regard, the World Bank notes that South Africa has probably reached the limit that can be achieved by fiscal policy and that further reductions in inequality require higher and more inclusive economic growth.

21. That study was based on 2010 data. Since then, South Africa's tax system has been made even more progressive as a result of the tax increases imposed and the manner in which they have been imposed. The result is that South Africa's tax system and fiscal system as a whole are highly progressive.

Tax mix

22. South Africa is forecast to obtain approximately 38.1% (10.2% of GDP) of its tax revenues from personal income tax, 24.7% from VAT (6.6% of GDP) and 17.3% (4.6% of GDP) from corporate income tax in 2017/18. Compared to OECD countries, South Africa is heavily reliant on corporate income tax in particular for tax revenues, with its contribution having risen from 10% of tax revenues and 2.4% of GDP in 1999/2000 to 26.5% of tax revenues and 6.9% of GDP in 2008/9. Over the same period, the contribution of personal income tax fell significantly while that of VAT stayed relatively consistent.

23. The below graph illustrates the contribution of the three main taxes over time as well as the shift in the tax mix. In particular, the severe dip in corporate taxes in 2009/10 should be noted.

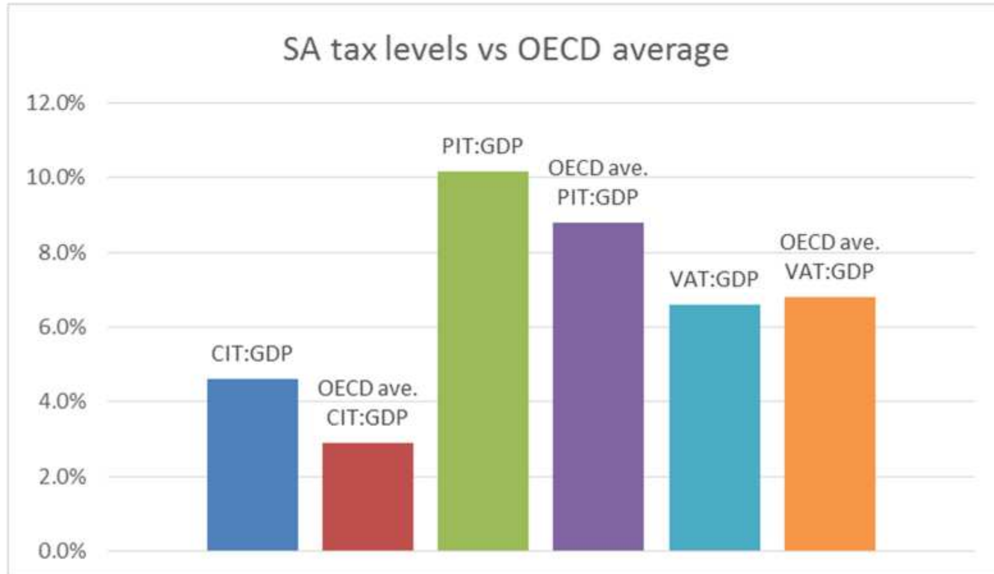


24. While there is no question that South Africa was overly reliant on individual taxpayers, the relief provided in this regard was possible as a result of base-broadening reforms and improved compliance in the corporate sector. The result is that South Africa has become overly reliant on corporate income tax while the tax burden on individuals has returned to (and now exceeded) the levels it was at in the early 2000's. This results in a number of disadvantages:

- Tax revenues are now more highly exposed to volatile corporate profits, as was illustrated in the wake of the 2008 global financial crisis. This resulted in a significant dip in corporate taxes in 2009/10 to less than 5% of GDP while the recovery has been slow in light of continued global and domestic challenges.

- Corporate taxes have been shown to have the greatest distortionary effect on economic growth. A high corporate tax burden therefore translates to lower economic growth.
- Personal income taxes are collected from a very narrow tax base with the overall tax burden now projected to reach record levels. The highly progressive nature of personal income taxes means that the bulk of this burden is borne by a small portion of the tax base. According to National Treasury, taxpayers earning more the R500 000 comprise just 13.7% of register taxpayers (some 1 million individuals), but will contribute 66.5% of personal income tax in 2017/18.
- High income taxes result in lower levels of savings. These in turn translate into lower levels of investment or a greater need to fund investment with foreign portfolio flows, impacting on the value of the currency and the cost of debt. Ultimately, lower levels of savings mean lower economic growth.
- By contrast, lower consumption taxes result in greater consumption, resulting in lower savings levels, negatively impacting the current account balance and leading to unsustainable consumption-led growth.

25. Research conducted by the OECD and other bodies suggests that growth-friendly tax reform would shift the tax burden from taxes on income (corporate tax in particular) to consumption taxes, such as VAT.
26. The OECD average for corporate tax revenues is 2.9% of GDP and 12% of tax revenues, personal income tax 8.8% of GDP and 33% of tax revenues and general consumption taxes 6.8% of GDP and 28% of tax revenues. Given the above, South Africa's tax mix is skewed to greater reliance on direct taxes and less reliance on indirect taxes. While this results in the tax system being more progressive, this comes as a trade-off with a tax system that would be more growth-friendly.
27. The below graph illustrates South Africa's reliance on the three main tax types relative to OECD country averages.



SACU

28. In terms of the SACU agreement, a combined revenue pool is created for purposes of sharing customs and excise duties while trade between the SACU member countries is duty-free. The combined revenue is shared between the member countries in terms of three formulas:

    - Customs duties are shared based on relative intra-SACU imports;
    - Excise duties are shared based on relative GDPs; and
    - A development component derived from excise duties is shared based on relative GDP per capita.

29. Unfortunately, the revenue sharing formula is weighted heavily against South Africa and in favour of the other member countries. Of particular concern is the formula for sharing customs duties. South Africa has significant trade surpluses with all other member countries. The result of these significant trade surpluses is that the bulk of customs duties in the combined revenue pool accrue to the other member countries, notwithstanding that the vast majority of customs duties collected relate to goods that are consumed in South Africa. To illustrate the point, the total value of imports by South Africa in 2014 amounted to R1.083 trillion. South Africa's SACU exports amount to approximately 83% of all intra-SACU trade. The result is that South Africa's share of the SACU customs pool amounted to only 17% for 2013/14.

30. To put the above into perspective, a more equitable sharing of the customs revenue pool would see South Africa entitled to at least 80% of the pool. The cost to South Africa is therefore at least R30 billion. This cost far exceeds the benefit for South Africa of being able to export goods to SACU members on a duty-free basis.

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31. The BLNS countries have now become heavily dependent on the SACU revenues. The result is that South African taxpayers are subsidising SACU member countries to a significant extent and this puts a large strain on South Africa's fiscal position. The below table illustrates how dependent the BLNS countries have become on SACU revenues, the strength of their fiscal positions and and how they compete favourably with South Africa on tax rates (Namibia is the exception).

	Botswana	**Lesotho**	**Namibia**	**Swaziland**
SACU revenue reliance	30%	44%	35%	50%
Corporate tax rates	22% (manufacturing/IFSC 15%)	25% (manufacturing 10%)	32% (manufacturing 18%)	27.5%
PIT top rate	25%	30%	37%	33%
VAT rate	12%	14%	15%	14%

32. The South African taxpayer is no longer in a position to be able to afford to subsidise the BLNS countries to the extent that it is currently doing. While the fiscal stability of these countries must obviously be taken into consideration in order not to destabilise the region, the agreement should be renegotiated over the medium term in order to provide for a more equitable sharing of revenues, failing which South Africa should withdraw from the agreement.

33. To this end, it was disappointing that no mention was made in the 2017 Budget of the progress of negotiations on a new revenue-sharing formula and little progress has seemingly been made in this regard. It is crucial, given the fiscal position of South Africa, that this formula is renegotiated as a matter of urgency.

Individuals

Personal income tax

34. The bulk of the additional tax revenues of R28 billion are proposed to be raised in the form of direct taxes amounting to some R23 billion. These direct taxes come in the form of very limited relief for fiscal drag in the personal income tax brackets and rebates, an increase in the top marginal tax rate from 41% to 45% for earnings in excess of R1.5 million and an increase in the dividends tax rate from 15% to 20%.

35. Unlike in the previous two years where tax increases were largely evenly distributed between direct taxes and indirect taxes, there has been a subtle shift in the 2017 Budget

to impose most of the burden of tax increases on personal income taxpayers, in general, and higher-income earners in particular. The result is that both the personal income tax system and the tax system as a whole will be made even more progressive than is currently the case.

36. While the rationale for this is well understood and can't be faulted on principles of equity, it does come with significant risks and trade-offs.

    - Firstly, direct taxes are more distortive than indirect taxes on consumption, that is, they reduce economic activity to a greater extent than indirect taxes and therefore are negative for growth. The result is that the manner in which the proposed tax increases are to be implemented is close to the worst option that could have been chosen (save for an increase in the corporate income tax rate).
    - Direct taxes result in a disincentive to save and invest. As such, the increases will likely result in a deterioration of South Africa's already poor levels of household savings. This is particularly so given that the bulk of household savings would come from the very persons targeted by the tax increases.
    - A significant risk to the fiscus resulting from the tax increases is a slip in tax morality and levels of compliance with taxpayers engaging in aggressive tax avoidance or even outright tax evasion. In this regard, the perception of how taxes are spent is crucial. While most reasonable taxpayers would accept that a key purpose of any fiscal system is to redistribute income from the rich to the poor, what is of real concern is if the taxes are wasted through ineffective, inefficient or corrupt activities. To this end, government has a social contract with taxpayers to spend its tax revenues wisely and for which it must be held accountable.
    - A related risk is that taxpayers could simply move elsewhere in order to avoid the tax. This risk is particularly pertinent when it comes to the band of taxpayers who have been targeted by the proposed 45% tax rate. These are the taxpayers with skills and wealth who are globally mobile. The country cannot afford to lose these people who, aside from their contribution to the fiscus, are crucial for economic growth and prosperity of the country as a whole.

37. Once levels of taxation reach a certain point, rather than increasing tax revenues, they actually result in a reduction in tax revenues as the disincentive elements outweigh the higher tax rates. This is graphically depicted by the Laffer curve.

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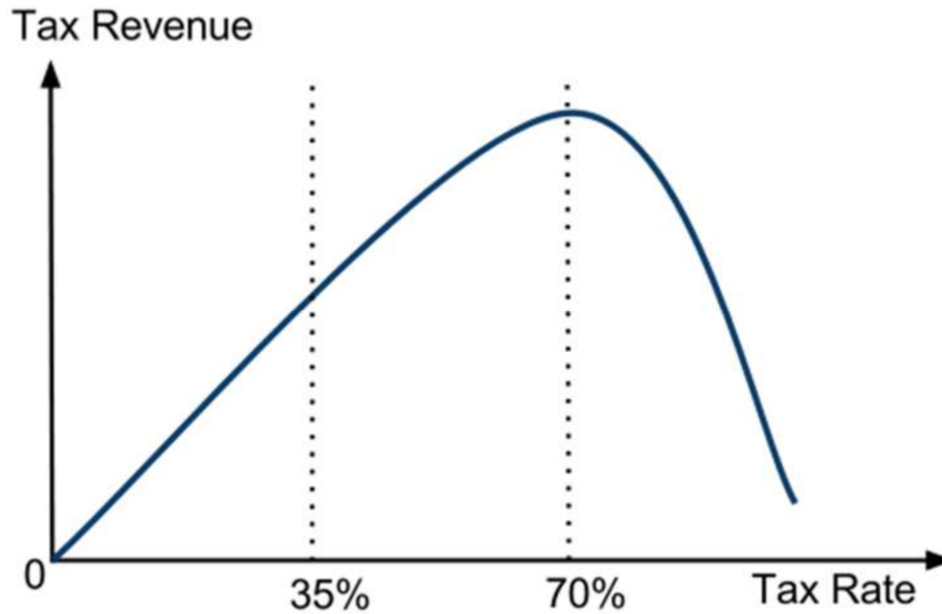

38. While no study has been made of the Laffer curve in the South African context, the indications are that personal income taxes are now very close, if not at the top, of the Laffer curve. Based on National Treasury's numbers, if just 3% of the taxpayers subject to the proposed 45% marginal tax rate (this is only 3 000 taxpayers) were to immigrate this would have a direct effect on personal income tax revenues of at least R3.8 billion. Importantly, this does not take into account the indirect negative effect that the loss of such taxpayers would have on other taxes, most notably VAT, and the knock-on effect on the economy as a whole, further eroding all other taxes. This must be compared to the estimated R4.4 billion that the increase to 45% is expected to raise.

39. In light of the above, we are of the view that there is no room to increase personal income taxes any further and that this tax instrument has been completely exhausted as a revenue source.

40. We note that we cannot reconcile our calculation of the effect of the increase in the maximum tax rate from 41% to 45%. Our calculations, based on National Treasury's own estimates of number of taxpayers and taxable income in this bracket suggest that the additional revenues should amount to some R6.5 billion rather than their estimate of R4.4 billion.

41. Given the disincentive effects of this is large tax increase on taxpayers earning over R1.5 million, we note that this could have been minimised by spreading the burden over a greater portion of the tax base. To this end, a 2% increase in the maximum tax rate for

those earning in excess of R750 000 would raise similar amounts of tax as the proposed 4% increase on those earning over R1.5 million.

Business

Company tax rates

42. We welcome the decision not to increase the tax rates on companies. As noted by National Treasury, South Africa's corporate income tax rate is relatively high by global standards. Any increase in the tax rate would negatively impact the country's competitiveness and increase its susceptibility to base erosion and profit-shifting. It is noteworthy that the global trend in corporate income tax rates is downward, with the stated intention of the likes of the UK and US to lower their tax rates to 15% over time.
43. We note the statement by National Treasury expressing the intention to broaden the tax base by reconsidering incentives and closing loopholes. We are broadly in agreement with this approach and note that the Budget contains a number of proposals that will close existing loopholes and, ultimately, increase corporate tax revenues.
44. However, we advise that any review of incentives should be carefully considered and be evidence-based. In this regard, we note that the Davis Tax Committee is working on a report on incentives.
45. Ideally, as the tax base is broadened, the company tax rate should be lowered in order to promote economic growth, in line with OECD studies on tax reform supporting economic growth.
46. The increase in the dividends tax rate from 15% to 20% is not ideal from an economic growth perspective. However, given the increase in the maximum marginal rate for personal income tax to 45% it is unavoidable in order to reduce the opportunity for arbitrage between the personal income tax rate and the effective corporate income tax rate after distribution of profits.
47. That said, we note that the dividends tax increase will ultimately largely fall on personal income taxpayers given the exemptions that apply and the reduced treaty rates that would be enjoyed by most foreign investors.

Indirect tax

Fuel taxes

48. Given the choices faced by the Minister in identifying a source for the additional tax revenues required for fiscal consolidation, we applaud the decision to increase fuel taxes as having the least damaging impact on long-term economic growth. However, as noted above, we are of the view that more could have been done to impose a greater portion of the tax burden of tax increases on indirect taxes, including the general fuel levy, given that these taxes are less harmful to economic growth than direct taxes.

VAT

49. Given that the personal income tax base has now been exhausted for further tax increases, we suggest that the VAT is now the only significant tax instrument available for further tax increases without doing considerable damage to the economy.

50. To this end, we submit that a serious engagement is required between all stakeholders to reach consensus in this regard. We remain of the view that an increase in VAT can be done in a manner which minimises the impact on the poor. There are several instruments available to achieve this, including the social grants system, the basket of zero-rated basic foodstuffs and the personal income tax system.

51. The proposal to remove the zero-rating on fuel is an intriguing option for raising additional VAT revenues. Economically, it makes sense that fuel should be subject to VAT at the standard rate. In theory, fuel is no different from any other goods and services and no good economic reason exists for it to not be subject to VAT. Most other countries do levy VAT on fuel. We look forward to engaging further with National Treasury in this regard.

52. It is imperative that these engagements take place well ahead of the 2018 Budget in order to properly formulate any proposal such that it can be implemented speedily.

53. We thank you for the opportunity to offer our opinion on the Budget fiscal framework and revenue proposals, and we trust that you find this to be of assistance in your deliberations. Please do not hesitate to call on us for further analysis.

Yours sincerely,

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