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Chair, Members,

Budget 2018 Fiscal Framework and Revenue Proposals – Preliminary Comment

1. We present herewith our initial commentary on the fiscal framework and revenue proposals included in the 2018 Budget Review.

A. Fiscal framework

2. As a country, South Africa currently faces one of its most testing challenges given weak economic growth, high unemployment and inequality, high revenue shortfalls, a 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. Matters were certainly not helped but the shock announcement of the introduction of free higher education for the poor which is expected to cost R67 billion over the next three years. This announcement effectively undermined National Treasury who had been tasked in November with finding an additional R25 billion in expenditure cuts and R15 billion in revenue enhancing measures for 2018/19.

4. The result was that National Treasury was able to only reduce the expenditure ceiling for 2018/19 by R8.5 billion, despite a reduction in baseline expenditure of R26.4 billion, after taking into account the additional funding required for higher education and drought relief. Over the medium term, the baseline expenditure reductions are clawed back in full by the increased expenditure resulting from free higher education with the result that there is actually no reduction in the expenditure ceiling in 2020/21.

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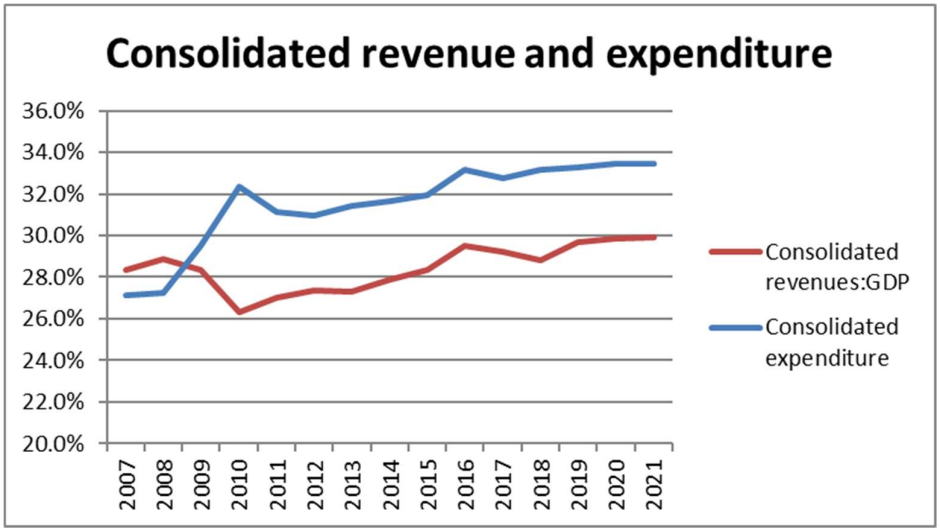
5. While fiscal consolidation is put back on track in 2018/19 as a result of the tax increases proposed, the deficit then remains sticky as it fails to fall significantly between 2018/19 and 2020/21, reaching only 3.5% of GDP. This is of concern. If the budget deficit is to be reduced over the medium term to below the benchmark 3% of GDP this will require far stronger growth than has been forecast, further expenditure cuts or further tax increases. Of concern is that there is seemingly little space, if any, left for further tax increases.

6. 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 33.2% of GDP in 2017/18 and is forecast to continue to grow over the next three years. By 2015/16, consolidated tax revenues net of SACU payments had recovered to 2007/8 levels and is forecast to continue to grow to reach 27.9% of GDP in 2020/21. As a result, the level of taxation is now at record levels.

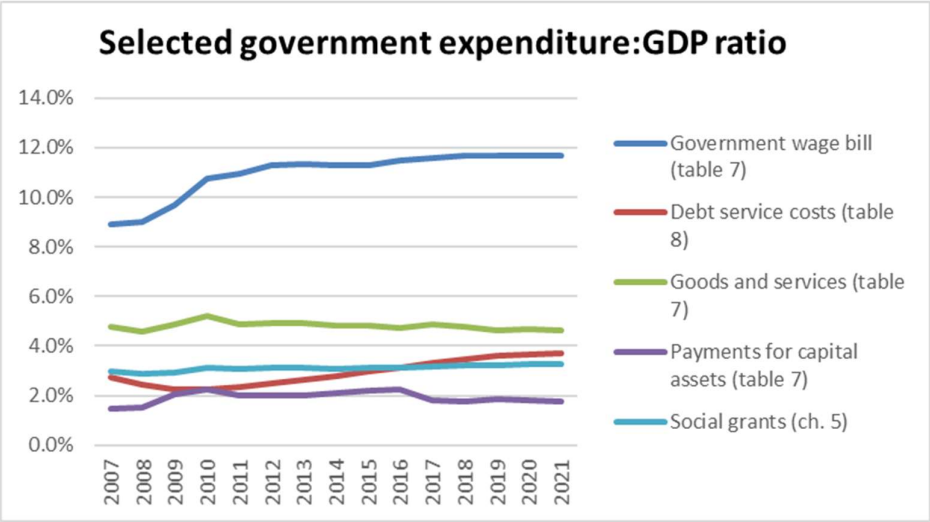
7. This problem is illustrated in the below graph which shows how expenditure growth has outstripped tax revenue growth. It is readily apparent that expenditure as a proportion of GDP needs to fall substantially over the longer term if the deficit is to be brought under control. It cannot be expected that revenues continue to rise towards the level of expenditure, especially if an initiative such as the proposed NHI is to be funded on a sustainable basis.



8. Given the above, we welcome the announcement by the President that a review of the configuration, number and size of national government departments is to be undertaken.

9. However, 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 11.7% 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.



10. It is therefore somewhat concerning that the budget forecasts the wage bill to continue to grow at an average annual rate of 7.3% over the next three years and by 7% in 2018/19, notwithstanding indications by the Minister that government cannot afford increases of more than inflation. It is hoped that government will work to limit increases to inflation at most. If increases in the wage bill are limited to inflation (including increases from promotions and notch progressions which add 1.5% to the annual increase on average), it would reduce government expenditure by R8 billion in 2018/19 and by R34 billion over the next three years.

11. As noted by National Treasury in the MTBPS, compensation now makes up in excess of 35% of total expenditure, up from 32.4% in 2008/9, and is increasingly crowding out other expenditure. It is of concern that over the last eight years compensation spending has increased by 4.1% annually in real terms with about 3.3% of this due to higher remuneration, rather than expanded employment. Public servants now earn significantly more on average than do employees in the private sector, with the exception of public servants at the highest income levels. It is significant that the median public servant earned over R260,000 in 2014 compared to the median taxpayer at R100,000.

12. Given the above, it is apparent that, on average, public servants are overpaid in comparison to the private sector and that a period of below inflation increases (and even a pay freeze), particularly in the current fiscal environment, would be appropriate. A pay freeze for 2018/19 would result in additional expenditure savings of R38 billion.

13. A further concern which has materialised (and is illustrative of the crowding out effect referred to above) is that the reductions in baseline expenditure have largely come at the

expense of infrastructure spending. It is noted that of the R85 billion cuts in baseline expenditure over the next three years, nearly R40 billion of this relates to cuts in capital transfers. This results in a shift in the composition of expenditure away from capital towards consumption. Some of these cuts relate to social infrastructure such as schools and housing while the rest relates to economic infrastructure such as roads, rail and water. Such cuts to social infrastructure spending will negatively impact the poor while cuts to economic infrastructure will negatively affect economic growth in the long term. Either way, such cuts are not desirable.

14. The result of this shift in spending away from capital towards consumption results in a continual current budget deficit over the medium term. This is not desirable. It effectively means that as a nation we are borrowing to put food on the table and clothes on our backs. This situation needs to be remedied by reducing consumption expenditure.

B. Revenue proposals

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

Tax increases and tax structure

16. We note that tax increases amounting to R36 billion are proposed. While this is certainly not desirable and will negatively affect economic growth, such increases are probably unavoidable if we are to avert further credit ratings downgrades. They are the price taxpayers need to pay for the corruption and mismanagement of the economy that has taken root in recent years. That said, they will be less painful than the effects of a credit rating downgrade by Moodys to sub-investment grade and, as such, are the lesser of the two evils.

17. However, taxpayers should not be taken for granted. It is clear that levels of tax compliance have slipped significantly over the last two years or so as the extent of corruption and mismanagement has become apparent and as taxpayers' trust in government has been eroded. This is clear from the fact that, despite significant tax increases, the gross main budget tax:GDP ratio has not increased and, in fact, is actually forecast to decrease slightly in 2017/18.

18. Unless urgent steps are taken to restore trust in government, there is a risk that this trend will continue and that the expected additional revenues from the proposed tax increases will not materialise.

19. We discuss below the manner in which the 2018/19 tax increases are proposed to be introduced.

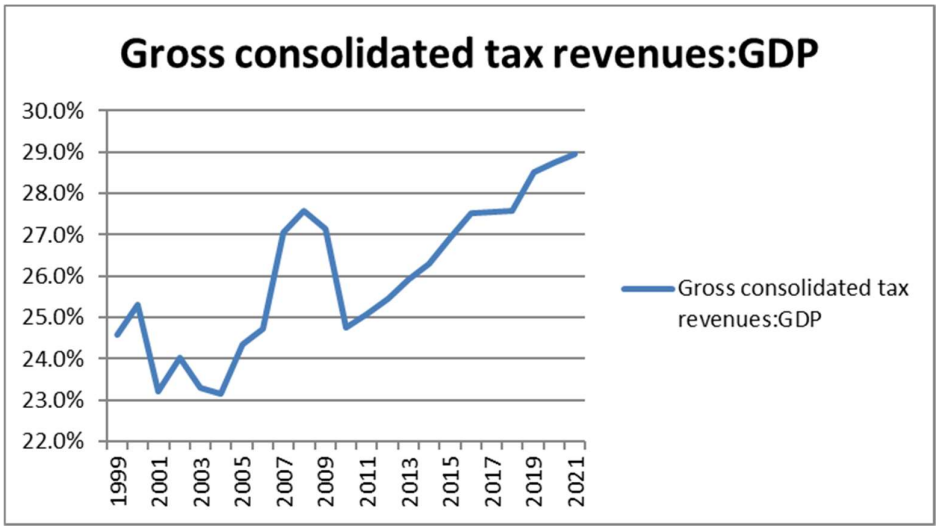
Level of taxation

20. 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

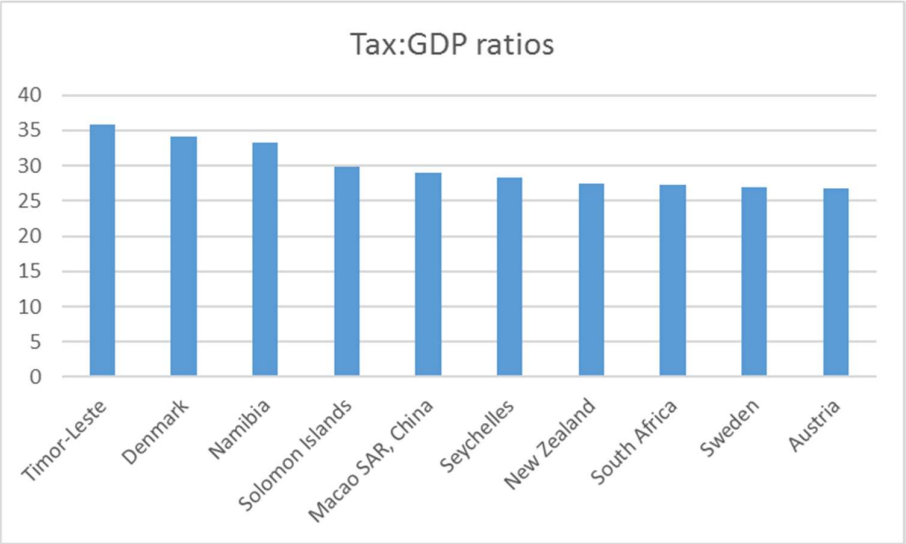
wake of the global financial crisis. However, tax revenues have since recovered to similar levels with the level of taxation estimated to be 26.4% of GDP for 2017/18, increasing further to 27.9% by 2019/20. The below graph illustrates the level of taxation from 1998/99 to 2020/21.

21. 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.

22. This graph illustrates the strong upward trajectory of the tax burden which reaches 29% of GDP in 2020/21. This constant increase in the tax burden is unsustainable in the long term. If this does not stabilise, it is likely to crowd out space for any further tax increases in order to fund such initiatives as the NHI and comprehensive social security reform.



23. Of concern is that, according to World Bank Group data, South Africa had the eighth highest tax:GDP ratio (excluding social security contributions) of all countries that have reported data for 2015. 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.



24. It is clear that South Africa has a high tax burden by international standards.

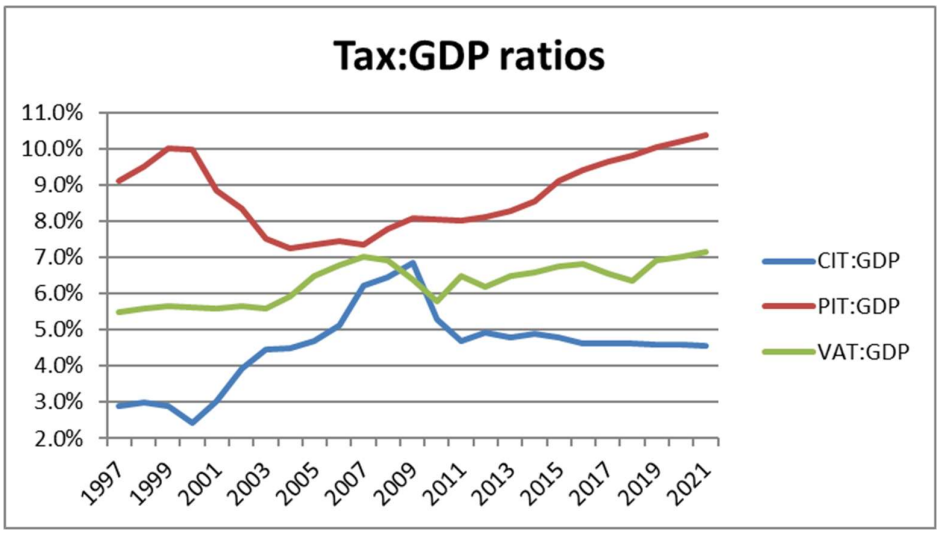
25. It is acknowledged that South Africa's high income and wealth inequality necessitates its fiscal policy to play a crucial role in reducing inequality and South Africa does extremely well in this regard with the largest reduction in inequality achieved by any of the countries studied to date by the 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.

26. 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

27. South Africa is forecast to obtain approximately 37.6% (10.1% of GDP) of its tax revenues from personal income tax, 25.9% from VAT (6.9% of GDP) and 17.2% (4.6% of GDP) from corporate income tax in 2018/19. 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.

28. 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.



29. 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.

30. Of all the OECD countries and African countries studied by the OECD as part of its Revenue Statistics research, South Africa places the highest tax burden on companies at 4.6% of GDP. See the annexure for a comparison of South Africa to such countries.

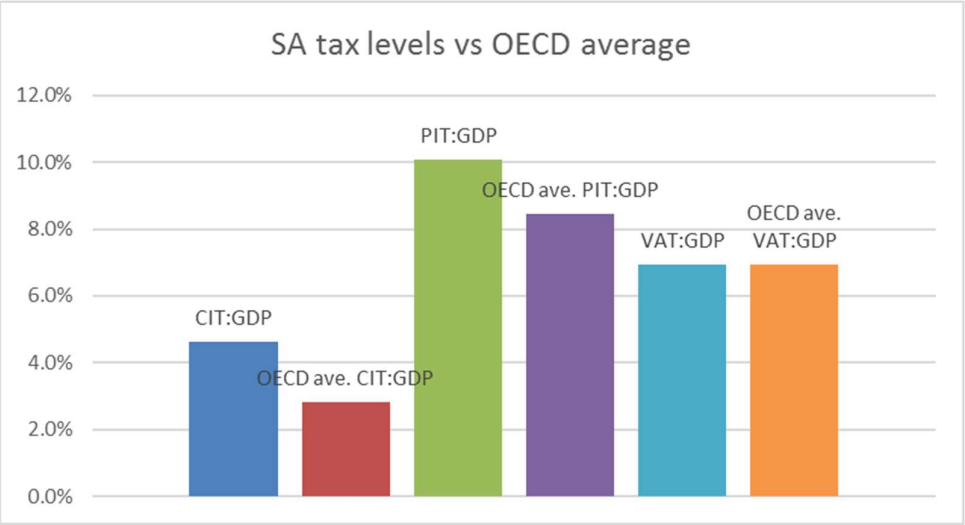
31. The result is that South Africa has become overly reliant on corporate income tax (with our companies suffering a high CIT burden compared to other countries) while the tax burden on individuals has returned to (and now exceeded) the levels it was at in the early 2000's. This results in a number 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. The high tax burden on South African companies means that our corporate tax system is relatively uncompetitive compared to our main trading partners and countries with whom we compete for investment.

- Personal income taxes are collected from a very small pool of taxpayers with the overall tax burden now projected to reach record levels. This tax burden is relatively high by global standards, exceeding the average for OECD countries and well above other developing countries. In addition, 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. Just 25% of those who pay income tax, pay 80% of all the personal income tax.
- High income taxes result in lower levels of consumption and savings. These in turn translate into lower economic growth. According to studies conducted by the OECD and others, personal income taxes are the next most damaging tax for economic growth after corporate income taxes.
- By contrast, consumption taxes are less damaging for economic growth.

32. 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. Of course, this means that there is a trade-off between the economic efficiency of the tax system and equity or the progressivity thereof. However, it is important to bear in mind that no single tax instrument should be considered in isolation in measuring the progressivity of fiscal policy. The totality of fiscal policy, comprising tax policy and spending, should be considered holistically when measuring the redistributive effect thereof. After all, most of the reductions in inequality through fiscal policy are achieved through spending and not through taxation instruments.
33. 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 relatively more progressive, it comes at a trade-off with a tax system that would be more growth-friendly.
34. The below graph illustrates South Africa's reliance on the three main tax types relative to OECD country averages taking into account the 2018/19 tax proposals.



Individuals

Personal income tax

35. We note that some R7.5 billion increases in PIT has been proposed. While such increases are probably unavoidable in the current circumstances, they will negatively impact economic growth and may well be viewed by taxpayers as being unjustifiable given the levels of corruption, wasteful expenditure and inefficiencies presently plaguing government.

36. In our submission on the 2017 Budget, we warned that "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."

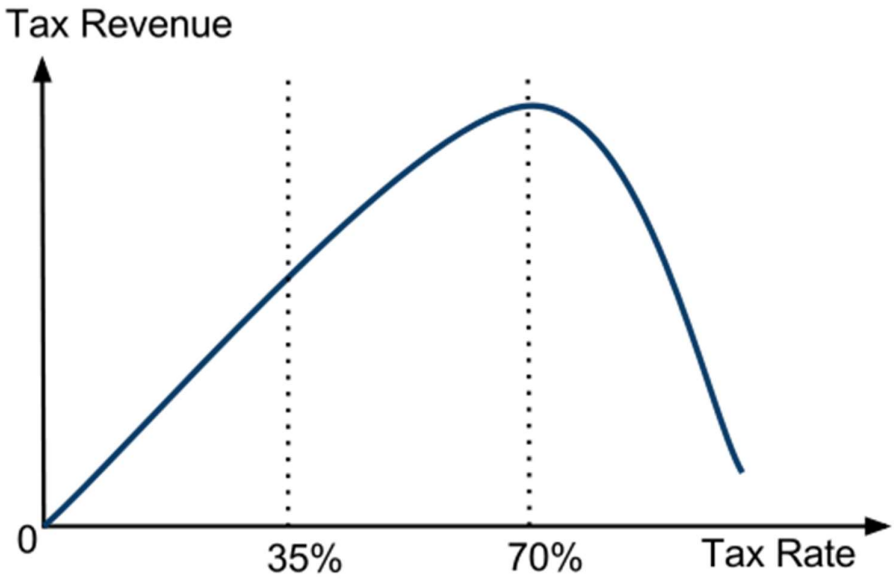
37. Unfortunately, this risk presented itself in full force. Instead of the anticipated R16.5 billion increases in PIT announced in the 2017 budget materialising, the revenues from PIT are anticipated by National Treasury to fall short by R21 billion. Our estimates suggest that the shortfall may be slightly higher at R22 billion.

38. It must be noted that this risk has not diminished to a significant degree, despite recent developments which suggest a better political and economic environment for the year ahead. There is therefore a risk that PIT revenues will once again fall short of estimates in 2018/19, particularly given the optimistic tax buoyancy ratio of 1.17 before the increases.

39. Once again, we make the following observations in the context of the proposed PIT increases:

- 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.

40. 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.



41. While no study has been made of the Laffer curve in the South African context, the indications are that personal income taxes are now at the top of the Laffer curve.

42. 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 now been completely exhausted as a revenue source.

43. This can be further supported by the fact that the estimated tax:GDP ratio for PIT for 2018/19 of 10.1% is well above the OECD average of 8.4%. This is even more so when regard is had to developing countries where the average tax:GDP ratio for PIT is around 4%. The impact of the overall tax burden is made worse by the fact that some 80% of PIT is paid by just 25% of taxpayers who pay PIT, resulting in the bulk of the tax burden being imposed on a small pool of taxpayers.

Estate duty

44. We note the increase in the estate duty rate and donations tax rate to 25% for amounts over R30 million in line with the recommendations of the Davis Tax Committee. However, we note that the other recommendations of the Davis Tax Committee in relation to the estate duty, most notably the scrapping of the spouse exemption and an increase in the abatement to R15 million have been ignored. The selective cherry picking of recommendations to support revenue raising initiatives should be guarded against.

Business

Company tax rates

45. 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 and the CIT burden is amongst the highest in the world. 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.

46. We note National Treasury continues to broaden the tax base and is reconsidering incentives and closing loopholes. We are broadly in agreement with this approach.

47. 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.

Indirect tax

VAT

48. We note the proposed increase in the VAT rate from 14% to 15% with effect from 1 April 2018.

49. Assuming that it is accepted that additional tax revenues of R36 billion for 2018/19 are a necessity in the absence of other fiscal consolidation measures, it is our view that National Treasury had no choice but to increase the VAT rate. As indicated above, we have simply run out of space for further significant PIT increases and there was no scope to increase CIT rates above their current levels. The result is that VAT is the only tax instrument left available to National Treasury to raise significant additional tax revenues.

50. It is acknowledged that, viewed in isolation, the VAT increase is regressive and will disproportionately affect the poor. However, no single tax instrument should be viewed in isolation when measuring vertical equity (progressiveness). In this regard, it is important to consider all tax instruments in conjunction with each other and to also consider the progressivity of expenditure such that the progressivity of the fiscal system as a whole is considered.

51. In this regard, it is noted that social grants are to be increased by above inflation to offset the effects of the VAT increase. The result is that grant recipients should not be worse off as a result of the VAT increase. In addition, greater relief from fiscal drag is provided for PIT taxpayers in the bottom three tax brackets which at least partially compensate them for the VAT increase. Furthermore, the VAT increase can be justified with reference to the introduction of free higher education for the poor.

52. The effect is that the overall progressivity of fiscal policy is likely to be maintained, despite the increase in the VAT rate. Despite this, there will obviously be losers as a result of the increase in the VAT rate, most notably the working poor and unemployed where there is no policy instrument available to directly alleviate the burden of the VAT increase.

53. On an unrelated note, it should be noted that the proposed effective date of 1 April 2018 will present significant problems for business. This is because significant systems changes will be required for many businesses to implement the change, often across multiple systems which were not designed with changes in the VAT rate in mind.

Fuel taxes

54. We note that a significant increase in the general fuel levy of well above inflation has been proposed. We note that the distributional effects of such an increase are similar to the VAT increase.

55. We also note that the RAF levy is proposed to be increased by a whopping 30c/litre or 18.4%. No explanation is provided in the Budget for this increase. However, it is apparent that, once again, the motorist is expected to bail out the RAF after years of corruption and mismanagement associated with the fund.

Ad valorem excise duties

56. We note the proposal to increase the *ad valorem* excise duties. This is certainly a more appropriate mechanism to increase the tax burden on luxury goods than the introduction of a higher VAT rate for luxury goods. It is also one way of ensuring that the burden of the VAT rate increase does not fall disproportionately on the poor.

Environmental taxes

57. We note that it is proposed that the plastic bag levy be increased by 50% to 12 cents and that the incandescent light bulb levy be increased by R2 to R8. While these tax increase

are expected to raise minimal additional revenues, the justification for the increases is difficult to justify given that none of the revenues from these taxes are currently recycled to achieve environmental objectives.

58. We also not the proposed increases in the vehicle emissions taxes. In the absence of the introduction of clean fuels in South Africa, we can't see how these increases can be justified.

59. The industry which stands to lose the most from this Budget is the motor industry which is hit hard with increases in *ad valorem* excise duties, vehicle emissions tax increases, fuel tax increases and the VAT rate increase. The coming carbon tax is also likely to negatively impact the industry insofar as input costs on such things as steel, glass and tyres are concerned. All of this will negatively affect the affordability of cars in South Africa. The policy rationale for the increased tax burden on this industry is hard to reconcile with the massive incentives (amounting to R27 billion 2015/16) directed at keeping the motor industry in South Africa and undermine the very purpose of these incentives.

Excise duties on alcohol and tobacco

60. We note that the increases in these taxes is significantly above the inflation for the products in question. The result is that the taxes levied will now be above the targeted tax burdens, which was already the case for beer and spirits before these increases.

61. Treasury should be required to clarify if the targeted tax burdens have now been increased as no explanation is provided in this regard.

62. 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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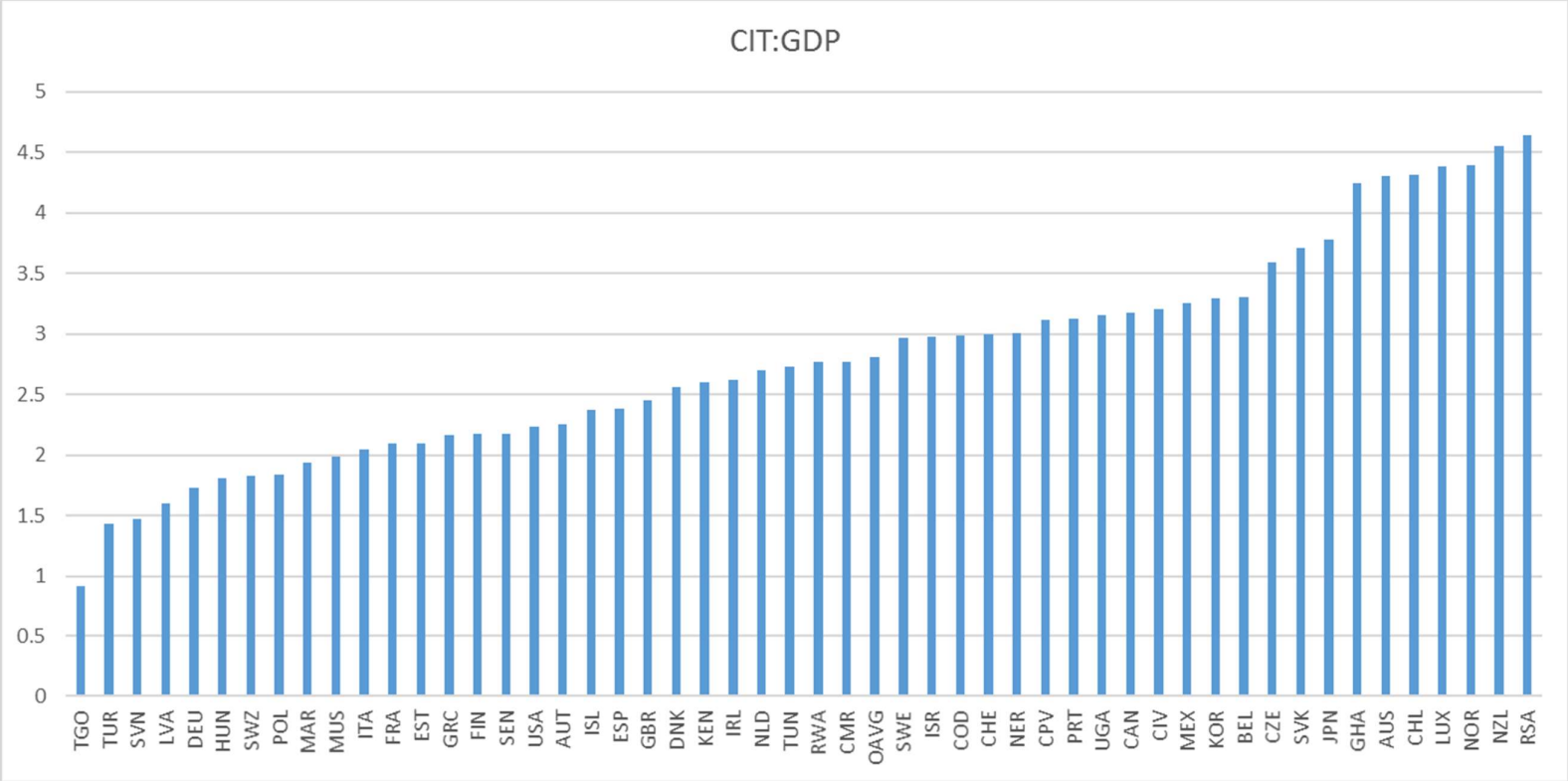
Annexure



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