Sec finance 27/11/18

# VAT Panel:
# Report to Parliament

August 2018

# Mandate and process

- Panel established to consider how to mitigate the impact of the increase in VAT from 14% to 15% in the 2018/9 budget
- Terms of reference essentially:
  - Evaluate whether the 19 already zero-rated food items in fact makes the tax more progressive and if they should be more targeted
  - Identify additional items for zero rating, taking into account benefits, costs, and practicality
  - Consider whether mitigation could not be better achieved through targeted expenditures
- Established in April 2018, with report due in July.

## Panel members

- Professor Ingrid Woolard (Chair)
- Ayabonga Cawe
- Professor Ada Jansen
- Dr Thabi Leoka
- Dr Neva Makgetla
- Lynn Moeng-Mahlangu
- Cecil Morden
- Prenesh Ramphal
- Professor Imraan Valodia

- Research and drafting support kindly provided by Mashekwa Maboshe and David Francis

# Approach

- The Panel agreed on core principles to guide its analysis and decision-making
- Priorities for zero rating were reflected inputs from the public
- Limited time meant that focused work on zero rating, with broader ideas on expenditure

- Consultations
  - 2000 written inputs
  - Meetings with NEDLAC constituencies

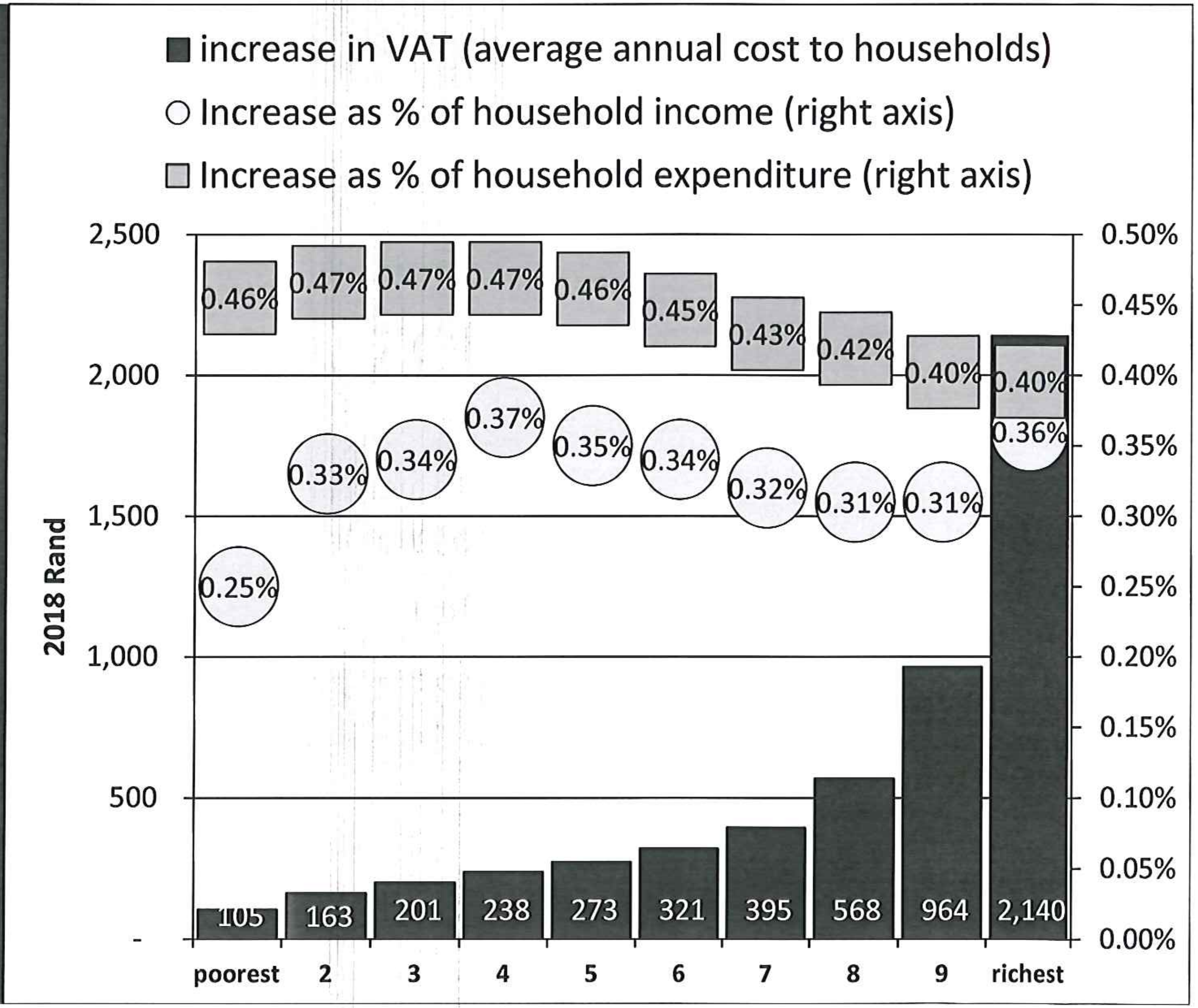
# Fiscal and socio-economic context

- Deficit remains relatively high since stimulus required in response to 2008/9 global crisis
- Decline in VAT revenue in constant rand in 2017/8

- But also:
  - SA remains amongst the most unequal countries in the world
  - Relatively slow and unstable growth since the metals boom ended in 2011

# The impact of the VAT increase

- Deep income inequalities mean rich households pay more in rand terms
- As a percentage of income and expenditure, the impact varies by decile but mostly around a third of a percent of spending
- Largest impact on households in the fourth to sixth decile, which spend roughly between R4000 and R6000 a month



# Principles – and trade offs

*The tax system should be as progressive as possible*

- Even with zero rating, VAT is less progressive than income and luxury taxes
- International experience shows that a progressive tax system is necessary to promote equality
- Particularly important for SA, where deep inequalities are a major hindrance to economic and social progress
- Cannot broaden the tax base by making the poor pay more

*VAT should be as progressive as possible*

- Zero rate products that absorb a higher share of spending for poor
- Measured in terms of impact on poorest 70% (essentially households with no employment, or informal or low-wage formal jobs)

*Cost of zero rating*

- Balance benefits to consumers against cost to fiscus
- Especially given relatively high deficit

*Ease of administration*

- Products should be easily defined – also to avoid circumvention by sellers
- Long lists impose burdens on smaller sellers

*Merit goods*

- Only zero rate where social benefits from consumption
- Take into account impact on disadvantaged/excluded groups

*Who benefits really?*

- Producers and sellers should not be able to capture benefits of zero rating
- Limited evidence, but apparently passed on to some extent

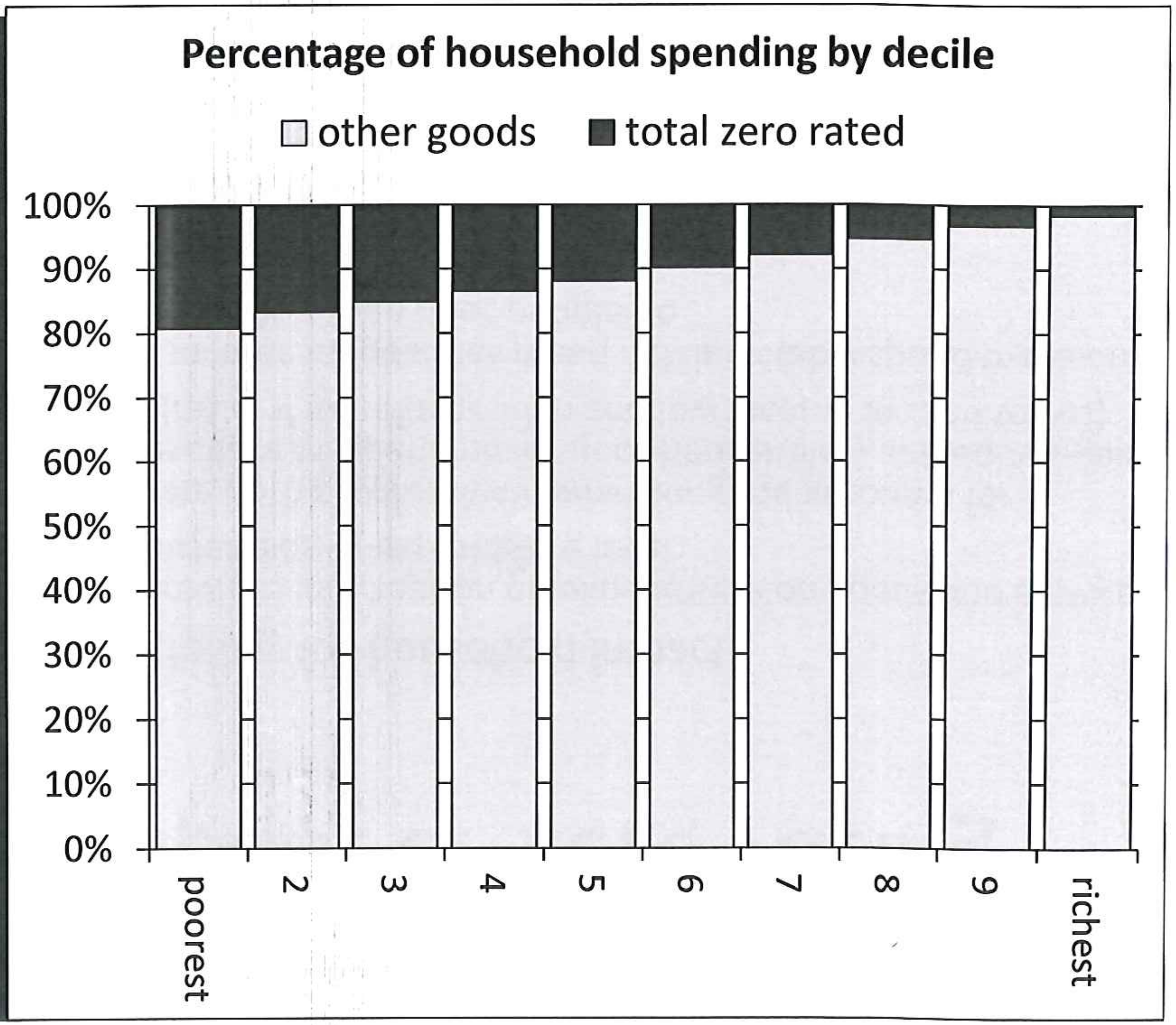
# Analysing the impact of zero rating

- Main evidence:
  - For impact on households by income level, Statistics South Africa Living Conditions Survey (LCS)
  - For cost to the fiscus, Statistics South Africa estimates of total sales of products
  - To evaluate merit, relevant research and public inputs

- Methodology for household impact:
  - LCS provides information on expenditure on goods and services by households by expenditure level
  - Evaluate both progressivity (whether good accounts for a higher share of spending for poor households) and equity-gain ratio (ratio of benefits to high and low income in rand terms)
  - Deep income inequalities mean rich inevitably spend more on most products than poor people do
- Cost to fiscus
  - Undercounting of total expenditure in LCS due to failure to record common purchases and undercounting of socially stigmatised goods
  - Undercounting primarily on foods; other products reasonably reliable
  - Panel estimated cost of proposals using data on total sales from StatsSA (developed for CPI weighting)
  - Differ from Treasury estimates, which use multipliers for entire categories of good – leads to much higher multipliers for basic foods than StatsSA sales data indicate

# Findings - current zero rating

- Overall, goods have a progressive impact and a strong equity-gain ratio – poor people consume a relatively high share
- Some fruit and vegetables are not very progressive
- Panel did not have time to separate out products
- Would need to explore trade offs of more selective approach in terms of higher administrative burden



# Other products

- Public submissions pointed to 66 products for zero rating, excluding some for which LCS did not provide data (e.g. yoghurt)
- Analysed to determine which were
  - Significant expenditure items (over 0,2% of household spending)
  - Relatively progressive in impact, with a significant equity-gain ratio (measured by the spending of poorest 40% as a ratio to the richest 20%)
  - Merit goods or particularly important to disadvantaged groups

- Eight products qualified for more in-depth analysis
  - Baby formula ("baby food consisting predominantly of milk")
  - Bread and cake flour
  - White bread
  - Disposable nappies
  - Poultry
  - Sanitary products and tampons
  - School uniforms
- For each, reviewed:
  - Incidence by household decile
  - Clarity of definition
  - Socio-economic justification
  - Cost to fiscus based on sales data

# Unanimous recommendations

- White bread, cake and bread flour – some nutritional concerns, but offset by progressive impact and significant for poor households
- Sanitary products – not highly progressive, but very important for women and girls; note that zero rating in itself insufficient to ensure access
- School uniforms – highly progressive and important to improve school access, but only viable if definitional issues can be addressed
- Nappies – progressive and particularly important for women, children, and some disabled and elderly people

- Estimated relief to the poorest 70% of households would come to R2,8 billion
- That compares to a total increase in VAT without additional zero rating of R3,1 billion
- Based on data for sales of these specific products, the cost in terms of foregone VAT for the fiscus would be R4 billion
- That is 17% of the total anticipated income from the increase of R23 billion

# Other products

- Disagreement on individually quick frozen (IQF) chicken
- Arguments against:
  - Definition is not sufficiently rigorous to avoid the inclusion of other poultry products, inflating the cost
  - Relatively high cost to fiscus
  - Would encourage higher poultry imports, which are already largely IQF
  - Benefits could be achieved through nutritional programmes
- Arguments for:
  - Staple food for low-income households, and imports help hold down the price
  - Progressive impact
  - Definition is industry standard and other frozen chicken is visibly differentiated

- Baby formula not recommended for zero rating
  - Recognise that imperative for some babies (where mothers have to go to work; require supplementary nutrition; or have high levels of HIV
  - But inputs from nutritional experts argued that formula is abused and can be bad for health, especially where high cost leads to inappropriate dilution or water is poor quality
  - Government should ensure available to low income households that require it

# Alternatives to zero rating

- Zero rating is a blunt instrument because cuts cost of products for all households, not just poor
- In theory, could compensate the poor through expenditure programmes, including
  - Providing products in kind
  - Cash transfers equal to cost of VAT

- Challenges in practice:
  - Reaching all poor households affected by VAT with sufficient resources to offset tax impact
  - Administrative and fiscal difficulty of scaling up both in-kind and cash programmes on a sufficient scale
  - To date, government has been unable to expand in-kind programmes to ensure comprehensive coverage

# Transfers of goods and services

- The government transfers a large share of tax revenue to the poor amongst others through nutritional support; subsidised housing; greater subsidies to education in low-income areas; public employment schemes; and free healthcare for low-income families.
- Using in-kind support programmes to mitigate the impact of the VAT increase on the poorest 50% would require an expansion in these programmes
  - by R1.8 billion above the amount they would have grown in any case, as measured for instance by the MTEF projections; and
  - in ways that ensure virtually all households in the poorest seven deciles benefit.
- The Panel had capacity to review only nutritional support programmes and the provision of sanitary products.

# Examples of in-kind programmes

*Nutritional support*

- National School Nutritional Support programme reaches 9 mn learners in poor communities (around three quarters of all learners)
- Current cost of R6,4 bn
- Would have to increase by around a third to compensate poorest 50% of households
- Would exclude households without school-going children or where the programme does not exist

*Sanitary products*

- Long-standing government commitment, but so far not implemented
- Providing an average of 20 sanitary pads every month for woman aged 13 to 55 in households would cost R240 per household
- Total cost would be R2,6 bn if reach poorest 50%, and R3,2 bn for poorest 70%
- Actual relief to households would vary depending on number of women

# Cash transfers

- Government has programmes to register poor households, notably for social grants, UIF and PAYE
- But:
  - Only social grants provide payments to most registered households
  - Systems do not indicate household incomes or expenditure, so would require substantial reforms to enable compensation equal to cost of VAT increase per household
  - Household expenditure patterns vary substantially, so providing an average refund would overcompensate some and undercompensate others
  - Informal workers and self-employed people do not pay either UIF or tax, so they are not included in these systems. Most, however, belong to households to get some kind of social grant.

# Examples of cash transfer options

## *Social grant system*

- Background
  - Half of households get a social grant of some kind, although targeted at those unable to work (excludes able-bodied unemployed)
  - 80% of households in poorest decile get a social grant, compared to under 10% in the richest decile
  - Old-age and disability grant would provide sufficient food for 2,7 people; child support grant, for 0,7 people
- Increase in the child support grant by R20 a month would cost just over R3 billion and more than compensate for VAT for the poorest 40% of households, *on average*
- Would not however benefit the 30% of households in poorest five deciles that receive no grants at all

## *UIF*

- In theory, UIF system registers all workers earning under R180 000 a year, so could provide a conduit for cash transfers
- In practice, however:
  - only 1,7 million actually contribute – likely that most very low wage informal and domestic workers excluded
  - Systems are also not designed to make payments for all members

# Conclusions

- We cannot as a society seek to extend the tax base by increasing the burden on poor households, because of SA's unusually large inequalities
- But any effort to mitigate the cost of VAT for the poor will cost the fiscus
- The VAT increase will cost poor households as a group around R3 billion – offsetting that cost is difficult because households differ in expenditure patterns and needs
- Zero rating is administratively easier to implement, but at least in theory harder to target than transfers to households in cash or in kind