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Chair, Members,

Budget 2019 Fiscal Framework and Revenue Proposals – Preliminary Comment

1. We present herewith our commentary on the fiscal framework and revenue proposals included in the 2019 Budget Review.

A. Fiscal framework

2. As a country, South Africa faces one of its most challenging periods ever given weak economic growth, high unemployment and inequality, high revenue shortfalls, a stubborn budget deficit, growing debt levels and spending pressures, particularly from state-owned entities (most notably Eskom). The fiscal risks faced by our country are significant.

3. At the same time, the country has run out of space for further tax increases to fund its expenditure demands and the reduction of the deficit.

4. Largely as a result of significant allocations for the reconfiguration of Eskom (totalling R69 billion over the MTEF period), National Treasury has increased the expenditure ceiling by R14 billion in 2019/20, R1.3 billion in 2020/21 and R732 million in 2021/22. This is despite baseline expenditure reductions of R50.3 billion over the MTEF period, as well as tax increases of R15 billion in 2019/20 and R10 billion in 2020/21.

5. The budget deficit, estimated at 4.2% of GDP for 2018/19, is estimated to grow to 4.7% of GDP in 2019/20, and then to only fall slightly to 4.3% and 4% of GDP in 2020/21 and 2021/22 respectively. This is of significant concern, especially in light of the 2018 Budget estimate of a deficit of 3.8% of GDP for 2018/19.

6. We must again emphasise that South Africa's deficit problem cannot (and should not) be addressed via the raising of taxes in order to raise additional revenue, but rather by addressing the conditions that give rise to poor economic growth and by focussing on the

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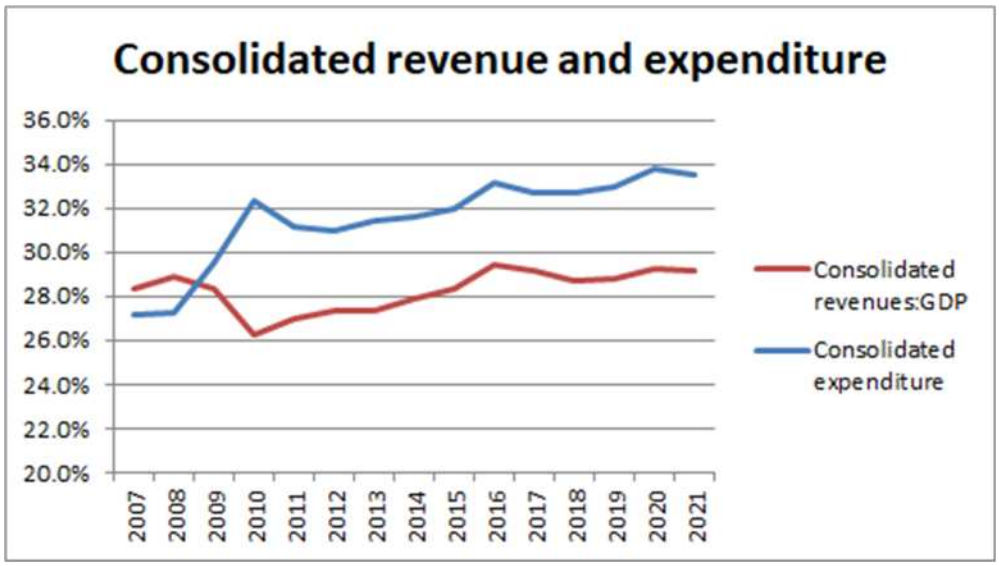
reduction of government expenditure. As set out later in this document, South Africa has run out of room to increase taxes further and the increases in recent years have become self-defeating.

7. Since 2007/08, consolidated expenditure has ballooned from 27.2% of GDP to 32.9% of GDP in 2018/19. This extraordinary growth has been funded to a great extent by increases in taxes via rate increases, which has had an adverse effect on economic growth, as well as increased deficits.

8. 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 tax increases will close the gap between revenues and expenditure. Just as importantly, it is important to get the economy on a faster economic growth path, which will be supportive of increased revenues.



9. Given the above, we welcome the discussion in the Budget Review regarding the turnaround and restructuring of Eskom, and look forward to the release of more details in this regard in the months ahead. We note that a commitment has been made that strict conditions will be attached to the fiscal support to be provided to Eskom to drive the changes that are required, including cost containment measures, and trust that fiscal support provided to other state-owned entities will carry similar conditions. It is unfortunate that, as a country, we have reached this point, and that taxpayers must come to the rescue of Eskom as a result of years of mismanagement and corruption. However, Eskom is too important to the economy to be allowed to fail and this is a case of the "least worst" option. We also note the statement in the Budget Review that financial support for state-owned entities beyond that provided for in the Budget will be raised from the sale of non-core assets and will be excluded from the expenditure ceiling.

10. As regards the public sector wage bill, it is acknowledged in the Budget Review that compensation accounts for more than 35% of consolidated public spending, and that this has, by itself, been a major driver of the fiscal deficit. It does, however, appear that some progress in reducing the wage bill has been made by government, with recent data showing a decline in employee numbers (owing to natural attrition) at a rate sufficient to absorb wage agreement pressures. In addition, we welcome the steps announced in the Budget Review to manage growth in compensation and create a more sustainable wage bill through natural attrition and active measures, such as the scaling up of early retirement without penalties and the change to the performance bonus payment system. The only reservation we have in this regard is that this process should include measures to ensure that valuable skills, possessed by experienced, senior employees, are not lost to the public sector. However, more does need to be done to drastically reduce the wage bill which, along with increasing debt service costs, is crowding out other expenditure in respect of social spending and infrastructure.

11. It was announced by the President in 2018 that a review of the configuration, number and size of national government departments was to be undertaken. Such a review could identify significant opportunities for savings in government expenditure. We are disappointed that this has not been addressed in the Budget and hope that concrete announcements will be made in this regard in the 2019 MTPBS.

Revenue Estimation

12. The table below illustrates the extent of the shortfalls in revenue collection against budget forecasts since the 2013/14 fiscal year. With the exception of the current fiscal year, the trend in revenue shortfalls since then has been steeply upwards.

Fiscal year	**2014/15**	**2015/16**	**2016/17**	**2017/18**	**2018/19**
Budget forecast	993,650	1,081,275	1,174,788	1,265,488	1,344,965
Actual revenues	986,295	1,069,983	1,144,081	1,216,464	1,302,201
Shortfall	7,355	11,292	30,707	49,024	42,764

13. Although it is appreciated that forecasting is an inherently difficult endeavour and that this difficulty has been compounded in recent years by weak economic conditions as well as operational problems experienced by SARS, the above data raises some questions as to the reliability of the forecasting models and processes adopted by the National Treasury.

14. The consistently significant shortfalls against forecast have, in our view, now resulted in a credibility concern with regards to the accuracy of revenue forecasting. To this end, we are concerned that there is a significant risk that the revenue forecast for 2019/20 could, once again, be overestimated.

15. National Treasury has used a tax buoyancy ratio of 1.31 in forecasting its revenue for 2019/20. When the base effects of clearing the VAT refund backlog and the proposed tax

increases for 2019/20 and 2020/21 are reversed out, this translates to tax buoyancy ratios of 1, 1.1 and 1.1 for 2019/20, 2020/21 and 2021/22 respectively. To put this in perspective, a tax buoyancy of 1 has not been exceeded in any of the last three years, even with the very significant tax increases in those years. Should a tax buoyancy of only 1 be achieved for 2019/20, this would result in a tax shortfall of R29 billion or 0.5% of GDP and would see the deficit increase to 5% of GDP, holding GDP and expenditure stable.

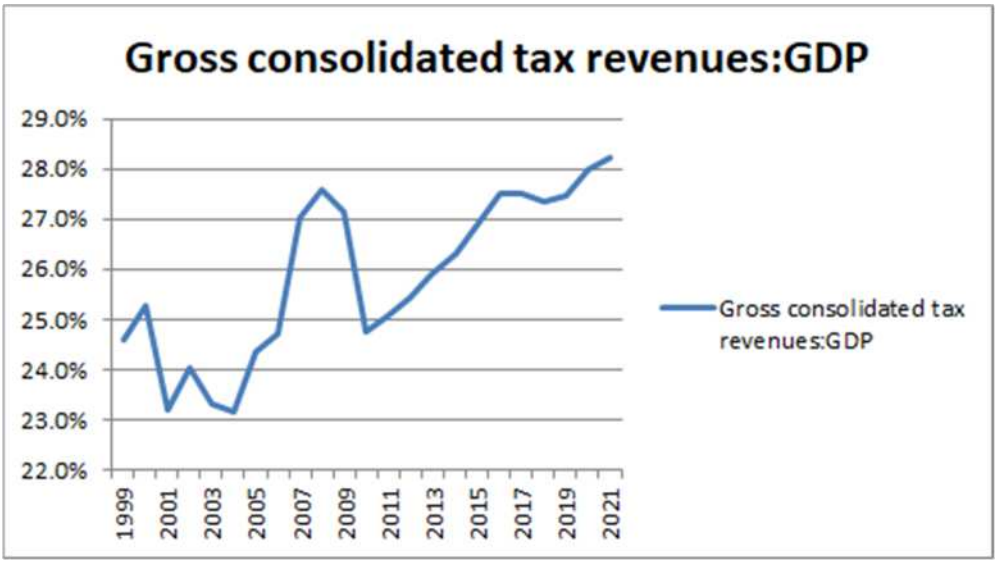
16. That said, the tax buoyancy ratios used in the forecast are not unrealistic or unreasonable when regard is had to the long-run tax buoyancy ratios achieved and, in normal circumstances, would be easily achievable. However, the circumstances in which South Africa currently finds itself are not normal circumstances and one gets the sense that National Treasury is placing too much store in the ability of SARS to substantially improve its performance in the next year and for levels of tax compliance and morality to improve significantly. It will take a number of years to rebuild SARS and recapacitate to the point where it is able to substantially improve its performance, even with the best will in the world.

17. We are therefore of the view that tax buoyancy constitutes a significant fiscal risk for the next year.

Level of taxation

18. It is important to bear in mind that the level of taxation in South Africa has been steadily growing since 2003/04 when the gross consolidated tax revenues before SACU payments stood at 23.2% of GDP. It reached a peak of 27.6% in 2007/08 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 27.4% of GDP for 2018/19, increasing further to 28% in 2019/20 and to 28.3% by 2021/22. The below graph illustrates the level of taxation from 1998/99 to 2021/22.

19. The graph illustrates the strong upward trajectory of the tax burden. The 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 (if this is not already the case in the current economic environment).



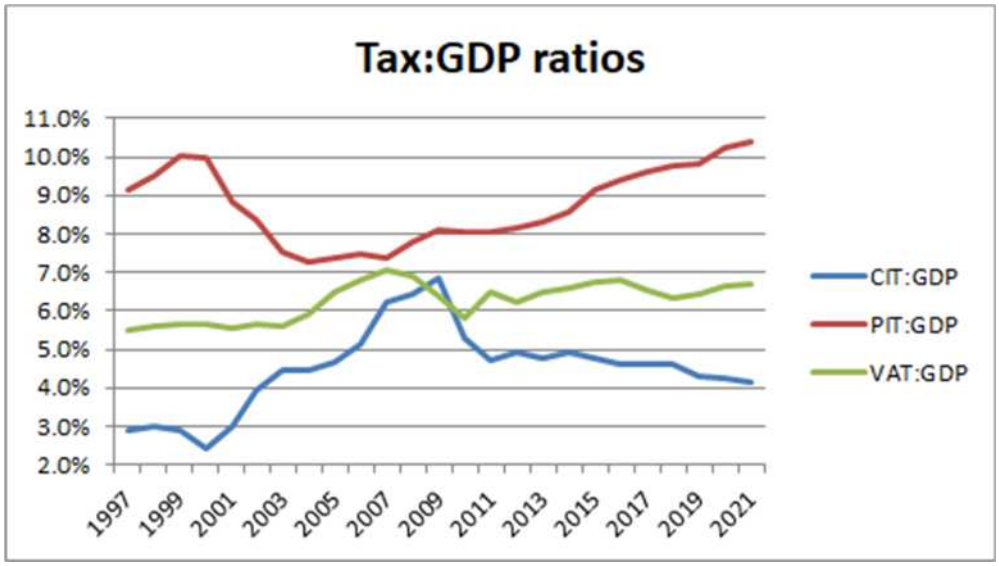
20. It is acknowledged that South Africa's high income and wealth inequality necessarily requires that its fiscal policy plays a crucial role in reducing inequality. South Africa does extremely well in this regard, with the largest reduction in inequality achieved by any of the countries studied to date by the World Bank (according to the World Bank's 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 implemented 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 38.9% (10.2% of GDP) of its tax revenues from personal income tax, 25.3% from VAT (6.7% of GDP) and 16.1% (4.2% of GDP) from corporate income tax in 2019/20. 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, as well as the recent declines in the contribution of CIT as corporate profits have come under pressure in a poorly performing economy.



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.

25. Of all the countries studied by the OECD as part of its Revenue Statistics research, South Africa places one of the the highest tax burdens on companies at 4.6% of GDP (2016 data). This is higher than all of South Africa's main trading partners.

26. The result is that South Africa has become overly reliant on corporate income tax (with our companies suffering a high CIT burden compared with other countries) while the tax burden on individuals has returned to (and has 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 and, more recently, the current fiscal year (i.e. 2018/19). This resulted in a significant dip in corporate tax revenues in 2009/10 to less than 5% of GDP while the recovery was slow in light of continued global and domestic challenges. Corporate tax revenues are now forecast to fall further to 4.3% of GDP this year.

- 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 those of 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, after corporate income taxes, the next most damaging tax for economic growth.
- By contrast, consumption taxes, because they do not distort savings and investment, have been shown to be less damaging for economic growth. Recurring taxes on immovable property (for example municipal property rates) have been shown to be the taxes that are most conducive to economic growth as they have a limited effect on the demand and supply of land.

27. 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, and recurring property taxes. 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.

28. South Africa's tax mix is skewed towards a greater reliance on direct taxes and less of a reliance on indirect taxes. While this results in the tax system being relatively more progressive, it comes at the expense of a tax system that is not as growth-friendly as it could be.

SACU

29. 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 formulae:

    - 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.

30. Unfortunately, the revenue sharing formulae are weighted heavily against South Africa and in favour of the other member countries. Of particular concern is the formula for

sharing of customs duties. South Africa has significant trade surpluses with all of the 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.

31. 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.

32. 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.

33. Given the fiscal crisis in which South Africa finds itself, it is difficult to justify South Africa's continued subsidisation of the BLNS countries to the extent that this is currently taking place. While the fiscal stability of these countries must obviously be taken into consideration in order not to destabilise the region, it is now urgent that the agreement be renegotiated in order to provide for a more equitable sharing of revenues.

34. This issue was raised in our submission to this Committee on the 2017 Budget. Since then, no mention has been made in any of the annual Budgets of any progress with any negotiations on new revenue-sharing formulae, and it seems that little progress has been made in this regard. Our understanding is that the BLNS countries are reluctant to renegotiate the revenue-sharing formulae. This is not surprising - it is akin to asking turkeys to vote for Christmas. It is, however, crucial (given the dire fiscal position of South Africa) that the formulae are renegotiated as a matter of urgency.

B. Revenue proposals

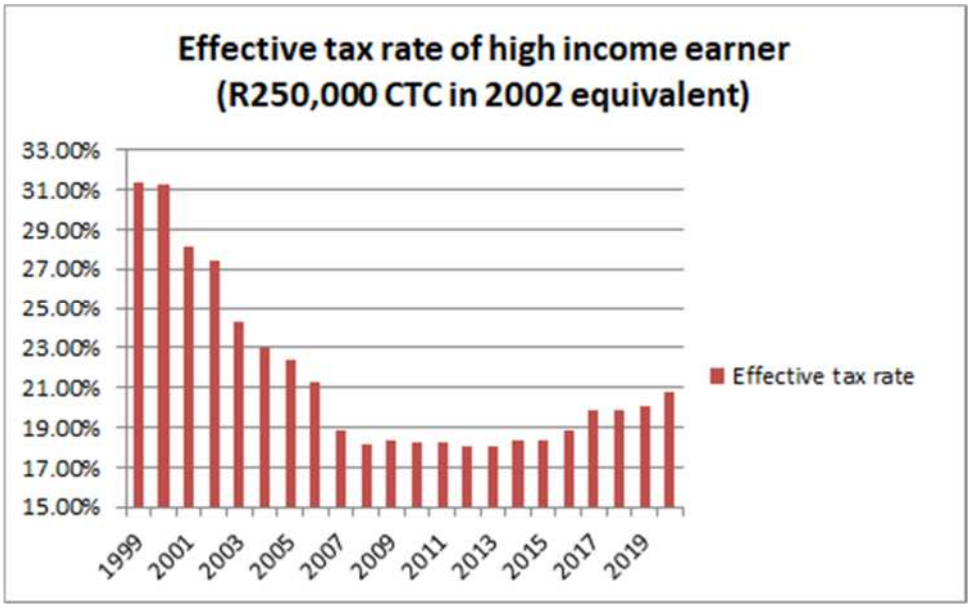
35. We set out below our comments on the revenue proposals.

Tax increases and tax structure

36. We note that tax increases amounting to R15 billion are proposed for 2019/20 and a further R10 billion of tax increases are proposed for 2020/21. Significantly, R13.8 billion of the total increase for 2019/20 is proposed to be raised by providing negligible fiscal drag relief (i.e. relief for the effects of inflation on personal income tax ("PIT")). This will be achieved by making no adjustments to the PIT brackets, nor to the medical tax credit. Although this might appear to be more palatable to many (on the basis that there have been no rate increases), it must be emphasised that a failure to adjust for fiscal drag is no

different to a rate increase (on the basis that all individuals will, effectively, be paying higher taxes on inflationary increases in their income).

37. The effect is illustrated in the below graph for a person earning approximately R660,000 today. It will be noted how the average tax rate has been creeping up since 2013/14. While the average tax rate is still significantly lower than those in the early 2000's, it must be noted that the graph oversimplifies the changes in tax burden over time because it does not take into account significant base-broadening reforms that also took place in the 2000's, such as the introduction of capital gains tax and the reform of the taxation of fringe benefits (e.g. travel allowances, share-based remuneration, company cars, entertainment allowances, etc.). The result is that the actual effective tax rate in the early 2000's would be significantly lower than that indicated where the same remuneration package had been structured tax efficiently.



Personal income tax

38. We take issue with the statement in the Budget Review that the 2019 Budget tax proposals are "designed to minimise the negative impact on growth". PIT is, after corporate income tax ("CIT"), the most economically inefficient of all tax types, and the significant increase in personal income tax will put an already strained consumer under more pressure, lead to a reduction in savings and consumption and ultimately result in lower economic growth.

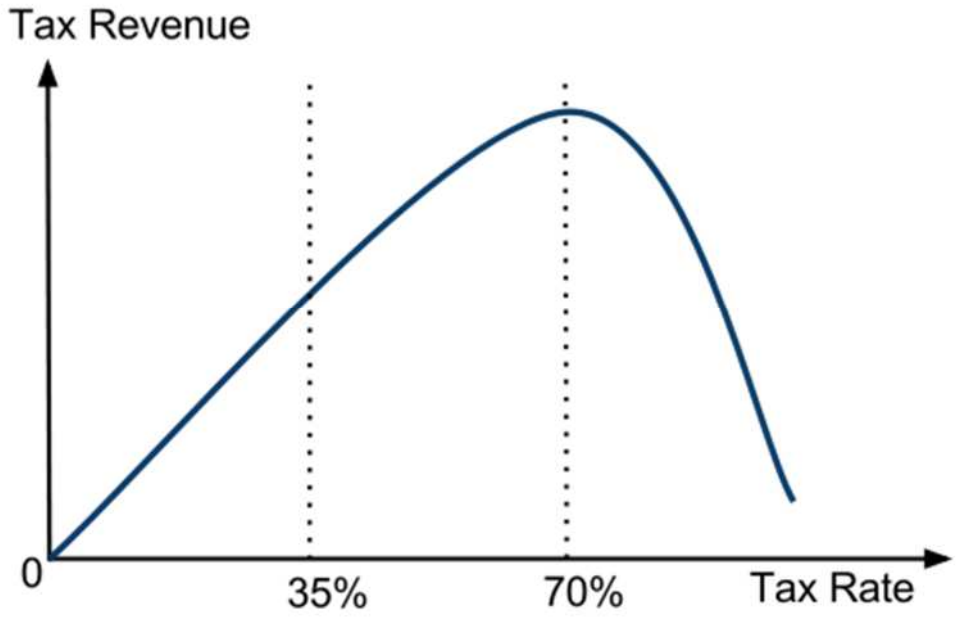
39. Regarding the negative effect of the proposed tax increases on economic growth, whilst it is acknowledged that government is under severe spending pressure, it is questionable whether these increases will ultimately translate into additional revenues in light of lower than anticipated revenues being realised in recent years following tax increases in

those years. Indications are that tax increases are having a pronounced negative effect on economic growth, thereby placing extra downward pressures on tax revenues (i.e. tax increases are becoming "self-defeating").

40. As we did last year in our submission to this Committee on the 2018 Budget, we make the following observations in the context of the proposed increases in PIT:

    - 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.
    - High taxes also act as an incentive for taxpayers to avoid or evade the taxes. It is apparent, from SARS's tax statistics, that there has been a marked decrease in the levels of compliance in recent years. The proposed increases will add to this incentive, particularly in the context of weak economic growth and the revelations of state capture and corruption on a grand scale that are now emerging.

41. 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.



42. While no study has been made of the Laffer curve in the South African context, the indications are that personal income taxes (and taxes in general) have now gone over onto the downward slope of the Laffer curve.

43. In our submission to this Committee on the 2018 Budget last year, we stated that we were of the view that there was then no room to increase personal income taxes any further and that this tax instrument had been completely exhausted as a revenue source.

44. This can be further supported by the fact that the estimated tax:GDP ratio for PIT 2018/19 has now stalled at 9.8%, despite significant tax increases in the 2018 Budget. In the 2018 Budget, tax increases to PIT of R7.5 billion were introduced; however, it is now forecast that the shortall in PIT collections will amount to R8.4 billion with the effect that the tax increases did not actually materialise.

45. The PIT:GDP ratio for 2019/20 is forecast at 10.2% (2018/19: 9.8%) and is well above the OECD average of 8.4%. In developing countries, the average tax:GDP ratio for PIT is around 4%. The impact of the overall tax burden is exacerbated 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.

46. The concern is, however, not limited to PIT. The overall tax burden is projected to reach record levels in 2019/20. However, it is apparent that, despite substantial tax increases in the last few years, the tax to GDP ratio has actually fall slightly instead of increasing, strongly suggesting that, in the prevailing social, economic and political environment, the level of taxation at which revenues are maximised has been exceeded.

47. We note too, that the burden of the PIT increase is, for the first time, largely shared proportionately across the different income levels. Once the decision was made to raise an additional R15 billion in taxes, this was inevitable as burdening high-income earners with the vast bulk of the tax increase would have done untold damage. It is a further demonstration that there is actually no room for these tax increases. Unfortunately, it is low-income earners who will bear the brunt of the tax increase as they have less capacity to absorb the increase and no ability to shield themselves from it.

48. The effect of the tax increases on taxpayer morality and tax compliance must also not be understated. Individual taxpayers, at all levels of income, will be severely affected by the increase in personal income tax. This could contribute to feelings of being "taken for granted", while they see what they perceive to be "bail outs" to state-owned entities such as Eskom, and could contribute to a further slipping in levels of compliance that have been experienced over the past few years. Individual taxpayers' trust in government has been eroded, and a significant tax increase does nothing to rebuild that trust.

49. We therefore repeat our warning in our submission made to this Committee on the Budget in 2017: "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.".

Business

Company tax rates

50. We again welcome the decision not to increase 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.

51. 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.

52. 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.

Proposed amendment to address abusive arrangements aimed at avoiding the anti-dividend stripping provisions

53. We note, as per Annexure C to the Budget Review, that government has identified certain avoidance arrangements that undermine the anti-avoidance rules dealing with dividend stripping. The Committee will recall that, in 2017, the rules governing share buy-backs and dividend stripping were changed to prevent taxpayers from avoiding taxation of share disposals by companies. In 2018, these rules were again adjusted to address concerns that the 2017 changes were harming legitimate corporate reorganisations. As per the Budget Review, it is proposed that, to curb structures that undermine the rules governing share buy-backs and dividend stripping, the rules be amended again and that the relevant amendments take effect on 20 February 2019.

54. We are aware of and supportive of the loopholes in question being closed. However, had National Treasury designed the rules appropriately in the first place, the loopholes would not have existed. The result of the poor design is that the rules are too broad in some respects and too narrow in others.

55. It is fully acknowledged that it takes time to promulgate legislation that addresses avoidance. Moreover, it is often necessary, in order to ensure that the anti-avoidance rules are effective, to announce that anti-avoidance rules will be effective from the date of the announcement (and not from the date of promulgation of the relevant anti-avoidance rules). It must, however, also be acknowledged that this approach creates a great deal of uncertainty and is extremely disruptive to business. To ameliorate such uncertainty, it would have assisted if National Treasury could have published, at a minimum, a draft of the proposed rules along with the announcement. We would therefore like to see National Treasury commence its consultations in this regard and issue draft legislation in this regard urgently.

Carbon tax

56. We note that the carbon tax levy on fuel is proposed to be introduced with effect from 5 June 2019. We also note that the carbon tax itself is to be implemented with effect from 1 June 2019. We have two concerns in this regard which we wish to bring to the Committee's attention.

57. Firstly, we note that the Carbon Tax Bill was amended to provide that the first tax period for the Carbon Tax would operate from 1 June 2019 to 31 December 2019. This is problematic as the tax is levied on carbon emissions for the tax period. However, carbon emissions are reported to the Department of Environmental Affairs for a full calendar year and not for a portion of the year. Accordingly, the proposed effective date is not in alignment with the Greenhouse Gas Reporting Regulations on which the tax is intended to be aligned and will create significant compliance and administration burdens should the proposed effective date be implemented.

58. Secondly, it was always intended that the carbon tax would be fiscally neutral. It is therefore concerning that the Budget suggests that the forecast revenues of R1.8 billion

from the carbon tax on fuel is to be used as a revenue raising instrument with no corresponding increase in expenditure to recycle the revenues.

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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