Standing Committee on Finance / Select Committee on Finance
Parliament of the Republic of South Africa
Plein Street
Cape Town
South Africa

By email: awicomb@parliament.gov.za

tsepanya@parliament.gov.za

nmangweni@parliament.gov.za

1 March 2021

Chair, Members,

Budget 2021 Fiscal Framework and Revenue Proposals – Preliminary Comments

1. We present herewith our commentary on the fiscal framework and revenue proposals included in the 2021 Budget Review.

A. Fiscal framework

The fiscal deficit

2. Even prior to the effects of the COVID-19 pandemic, South Africa faced an extremely challenging economic environment, characterised by weak economic growth, high unemployment and inequality, high revenue shortfalls, growing debt levels, and spending pressures (particularly from state-owned entities).

3. The COVID-19 pandemic has resulted in increased uncertainty, and its effects are far-reaching. As a result of increased expenditure necessitated to address the effects of the pandemic, as well as the effect of the pandemic on revenues, the budget deficit of 5.7% in 2019/20 has widened to an estimated 14% in 2020/21, the highest in South Africa's history. Before the pandemic, Budget 2021 estimated a deficit of 6.8% of GDP in 2020/21, still high and unsustainable by any measure. Although the 2021 Budget forecasts a narrowing of the deficit over the medium term to 6.3% in 2023/2024, significant risks remain to this forecast. In this regard:

   - Further lockdown measures that may be necessitated by further waves of COVID-19 infections could have a significant effect on economic activity and growth (and therefore revenue collections), and could require additional expenditure to, for example, mitigate the effects of such lockdown measures;

PricewaterhouseCoopers Tax Services (Pty) Ltd.
4 Lisbon Lane, Waterfall City, Jukskei View, 2090, Private Bag X36, Sunninghill, 2157
T: +27 (0) 11 797 4000, F: +27 (0) 11 209 5800, www.pwc.co.za

- Even in the absence of further shocks to the economic recovery, growth may be slower than forecast, having a negative impact on revenue collection;
- A slower than anticipated COVID-19 vaccine rollout could further complicate the situation, and itself result in further waves and a slower than expected economic recovery;
- The fiscal framework assumes compensation budget ceilings are maintained over the medium term - with most of the expenditure reductions announced in the 2020 and 2021 budgets dependent on wage bill reductions, this presents the most significant immediate risk to fiscal consolidation; and
- The financial positions of public entities and local government remain weak as a consequence of poor financial management, placing the risk of further support required from national government at an elevated level.

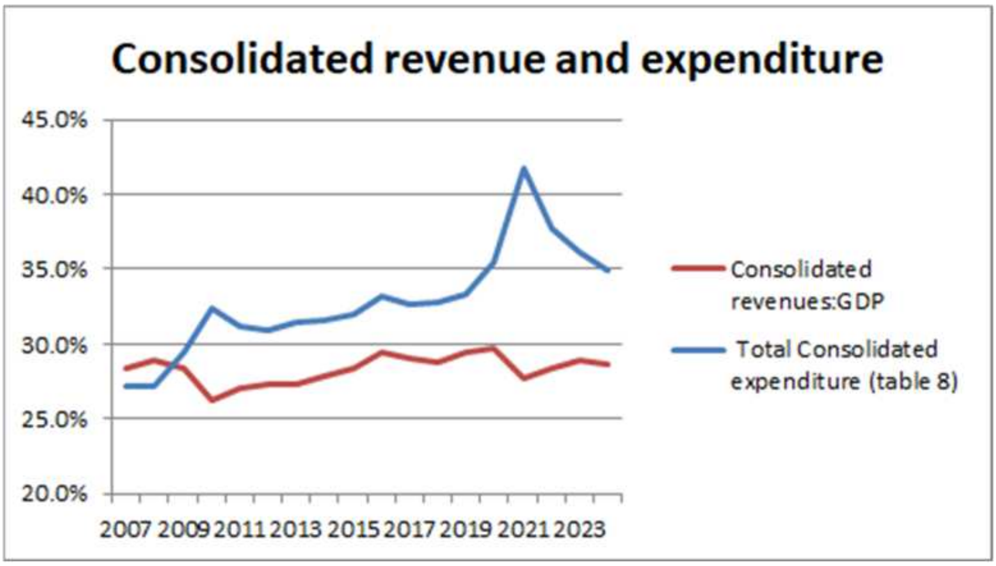
4. Since 2007/08, total government expenditure grew from 27.2% of gross domestic product (GDP) to 35.4% in 2019/20. For 2020/21, total government expenditure is estimated to be 41.7% of GDP. Consolidated revenues (net of SACUpayments) as a percentage of GDP, however, only increased from 28.9% of GDP to 29.7% of GDP in 2019/20 over the same period, and is estimated to decrease to 27.7% of GDP in 2020/21. Consequently, not only has growth in government expenditure far outpaced growth in revenues over the period, revenues (as a percentage of GDP) are estimated to have contracted to below 2007/08 levels for 2020/21.

5. In 2019/20 the consolidated revenues of 29.7% of GDP was at a record level. Notwithstanding this, expenditure growth has far outstrippedrevenue growth. The obvious conclusion is that the increase in expenditure from 2007/08 to 2019/20 of 8.2% of GDP has been unsustainable. The major contributor to this growth has been the compensation bill, which grew from 9% of GDP to 12.1% of GDP in 2019/20 (or by 3.1% of GDP). Transfer and subsidies have also increased substantially from 9.5% of GDP to 11.7% of GDP (or 2.2% of GDP) in this period. These include transfers to local government, households, higher education institutions, etc. Debt services costs grew from 2.4% of GDP to 4.9% of GDP as a result of the large fiscal deficits since 2009/10.

6. It is clear from the above that the driver of the structural fiscal deficit is unsustainable increases in expenditure and not a temporary revenue problem. As such, the solution to the problem lies in a structural reduction in expenditure, rather than in further tax increases. It is readily apparent that the significant tax increases in recent years have not delivered the expected revenues, but have instead had a detrimental impact on economic growth and levels of compliance.

7. Although Budget 2021 makes a strong and welcome commitment to reducing non-interest expenditure over the medium term (primarily through restraining growth in the public sector wage bill), there is still a large disparity between revenue and expenditure,

and this disparity (and the resulting fiscal deficit) will continue over the medium term, as is clearly illustrated in the below graph.



Revenue and the fiscal deficit

8. The strict lockdown implemented in South Africa in March 2020 severely limited economic activity. In addition, government provided tax relief measures to households and businesses in the form of tax deferrals and direct tax relief. The inevitable result was a steep fall in tax revenues. Accordingly, Budget 2021 estimates gross tax revenue for 2020/21 to be 10.6% lower than for 2019/20, and R213.2 billion lower than projected in Budget 2020. This shortfall is, however, lower than the shortfall of R312.8 billion estimated in October 2020 in the 2020 MTBPS, largely as a result of significantly higher-than-expected corporate income tax, personal income tax and VAT collections in the three-month period ending on 31 December 2020.

9. Based on revenue collection figures released on Friday 26 February, we believe that the outlook for the remainder of the 2020/21 fiscal year has further improved, and we estimate gross tax revenues to be at least R13 billion better than predicted in the 2021 Budget. Moreover, should revenue collections for February and March 2021 only be 1.6% lower than the corresponding months in 2020, as was the case in January, revenue collections could exceed that in the 2021 Budget by more than R30 billion. As such, we regard the revenue forecast for 2020/21 to be conservative.

10. Budget 2021 announced that tax increases of R40 billion over the medium term (first announced in the 2020 special adjustments budget and confirmed in the 2020 MTBPS) will be withdrawn. This measure was announced to help stabilise public debt and return the public finances to a sustainable position. In our view, in light of the improved revenue outlook since MTBPS 2020 and to the end of the current fiscal year, this is the

correct approach and will support economic recovery (and therefore, ultimately, growth in revenues) by reducing financial pressure on households and businesses. We accordingly welcome this announcement.

11. Although the upward revisions to revenue estimates in 2020/21 should flow through to higher medium-term revenue projections in almost all categories, we note that Budget 2021 does, however, acknowledge that these higher projections do depend on a strong and sustained economic rebound. In this regard, personal income tax collections remain under pressure due to the elevated levels of unemployment flowing from the pandemic, and – given the uncertain economic outlook – there is a risk that revenue may underperform estimates. Moreover, Treasury acknowledges that the faster than expected recovery in the current year implies that revenue is likely to grow more slowly over the medium term. We agree with these sentiments and the reduced buoyancy numbers used in the forecast by Treasury are therefore appropriate in the circumstances.

Expenditure and the fiscal deficit

12. Regarding the expenditure component of the fiscal deficit, prior to the onset of the pandemic, the two primary drivers of the rapid increase in expenditure since 2009 were the public sector wage bill and debt service costs. In addition, spending pressures from state-owned entities also exerted significant upward pressures on expenditure.

13. The pandemic has, over the current fiscal year, added additional spending pressure on government in the form of short-term support to low-income households and funding for the health policy response. Interventions in this regard include the special COVID-19 social relief of distress grant, the UIF Temporary Employer/Employee Relief Scheme, and funding for employment initiatives, as well as funding for public hospitals and the rollout of the vaccination campaign.

The public sector wage bill

14. We are in full agreement with statements made in Budget 2021 to the effect that the sustainability of South Africa's public finances will depend heavily on government's ability to reduce growth in the public sector wage bill.

15. Previous editions of the Budget Review and MTBPS have consistently highlighted the problem of the public sector wage bill consistently being one of the fastest-growing items of expenditure, increasing faster than growth in GDP. Public service compensation absorbed 41% of government revenues in 2019/20, which is estimated to increase to 47% of GDP in 2020/21. According to the Budget Review, South Africa's wage bill is at 14.8% of GDP, which is 4.6 percentage points higher than the average for the Organisation for Economic Co-operation and Development countries and lower only than Denmark and Norway.

16. Budget 2021 therefore appropriately acknowledges that allowing the wage bill to continue rising in line with the trend since 2007/08 is simply not sustainable, and would

require a substantial reduction in much-needed funding for capital investment and critical public goods and services.

17. We therefore welcome the commitment made in Budget 2021 to restrain growth in the public sector wage bill, and fully support the measures to be taken in this regard, including:

- doing away with the annual cost-of-living adjustment in the public service up until 2023/24;
- introducing measures to reduce headcounts through a combination of early retirement, natural attrition and the freezing or abolition of non-critical posts (subject to these not negatively impacting service delivery);
- harmonising allowances and benefits, as well as abolishing or amending certain allowances and benefits;
- reconsidering pay progression rules;
- reviewing occupation-specific dispensations; and
- phasing out of performance bonuses.

18. Regarding future wage negotiations, we further fully support government's undertaking to negotiate on the basis of fairness, equity and affordability, noting that any agreement that makes provision for increases that exceed budget amounts will present a significant risk to the fiscal framework and will risk the country facing a debt crisis.

Public sector institutions, including state-owned entities ("SOEs")

19. The financial position of many public sector institutions remain weak, largely as a consequence of poor financial management. Moreover, as would be expected, the COVID-19 pandemic severely disrupted plans of public sector institutions in addressing their weak financial positions by curtailing revenue growth and the collection of arrears. At the same time, most operational costs remained inflexible. The result is that many public sector institutions that were already in financial distress are at risk of defaulting on their debts.

20. Despite the above, we note that, aside from an allocation of R7 billion for purposes of recapitalisation of the Land Bank, Budget 2021 does not appear to make any additional allocations to troubled public sector institutions and SOEs such as Eskom, Transnet, Denel, ACSA and the SABC. Instead, it appears that problems within public sector institutions are to be addressed through previous allocations and by operational and financial restructuring, together with (as was announced in the 2021 State of the Nation Address), a re-evaluation by government of the mandates of all SOEs to ensure that they are responsive to national development needs. It is not entirely clear, from the Budget Review, whether any additional allocation has been made to SAA but, to the extent that this is the case, we would question the appropriateness of supporting an airline which

appears doomed to fail and serves no apparent purpose that cannot be met by other privately owned airlines.

21. While we welcome government's approach in this regard, as well as its efforts to maximise the use of previously allocated funding, together with appropriate operational and financial restructuring measures, the ongoing risk posed by the precarious financial position of many public sector institutions should not be underestimated. Of particular concern is the risk posed by Eskom – as economic recovery progresses and demand for power grows, Eskom supply will remain under pressure, which could necessitate the need for further spending. More generally, without rapid improvements in financial management of public entities, they will continue to put pressure on public finances. The extent of such risks is not, in our view, adequately addressed in Budget 2021.

Zero-based budgeting

22. An overarching concern with government expenditure has, for some years, been that government does not get good value for money in public spending. A series of spending reviews conducted in 2020 has highlighted significant restructuring opportunities (i.e. merging or closing entities to reduce duplication of functions), and exposed large inefficiencies in spending. Importantly, these reviews have, as acknowledged by Budget 2021, revealed the limits of incremental budgeting – guaranteed increments in previous allocations invariably create further inefficiencies, as well as create perverse incentives to enter into contracts that have high unit costs.

23. We therefore welcome, and fully support, the announcement in Budget 2021 that, during 2021/22, the Department of Public enterprises and the National Treasury will pilot zero-based budgeting, thereby producing significantly re-costed budgets from 2022/23 and ultimately improving the efficiency of spending.

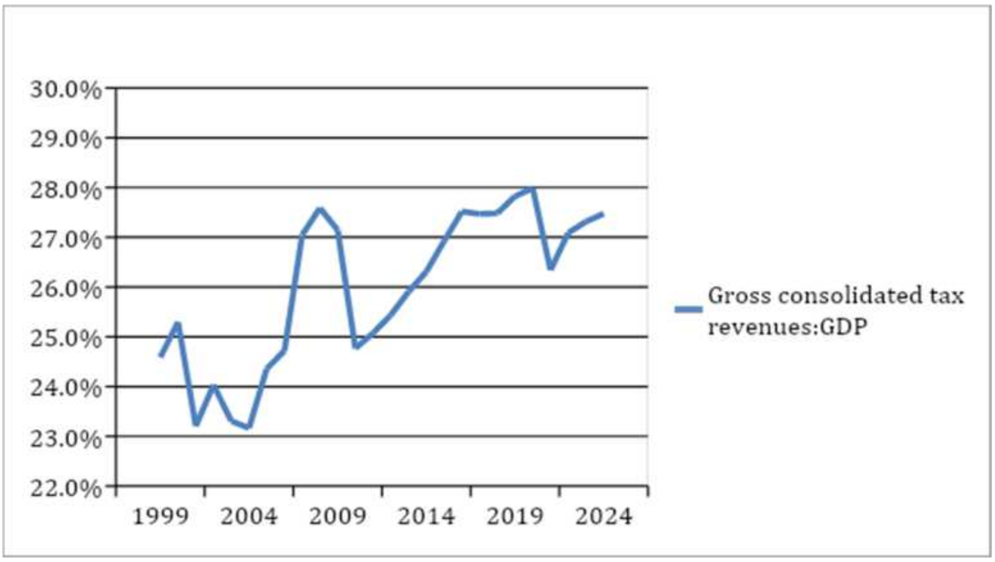
Improving the composition of expenditure

24. Generally, the thrust of the policy announcements relating to expenditure is to shift the composition of expenditure towards capital investment, to improve the quality of expenditure. We are fully supportive of this approach, which will facilitate the stabilisation of debt, reduce borrowing costs and the cost of capital, thereby providing a greater incentive for investment that will support economic recovery and growth. However, we note that the government's balance sheet is severely constrained and it has little capacity to invest in infrastructure. It is therefore crucial that the government partners with the private sector to unlock investment in public infrastructure, particularly in network industries such as electricity, road and rail.

Level of taxation

25. In 2003/04, gross consolidated tax revenues (before SACU payments) stood at 23.2% of GDP. This ratio reached a peak of 27.6% in 2007/08 before falling substantially in the wake of the global financial crisis. Between 2009/10 and 2019/20, tax revenues

recovered, and the level of taxation reached 28% of GDP in 2019/20. The distortionary effect of the pandemic on both GDP and gross consolidated revenues has resulted in revenues being estimated at 26.3% of GDP for 2020/21, recovering to 27.5% of GDP in 2023/24. The below graph illustrates the level of taxation from 1998/99 to 2023/24.



26. This year's proposals to limit tax increases to increases on excise duties and to provide real relief for individual taxpayers indicates that stabilisation is expected in the medium term. It should, however, be noted that the above is premised on the assumption of real growth in GDP over the next three years.

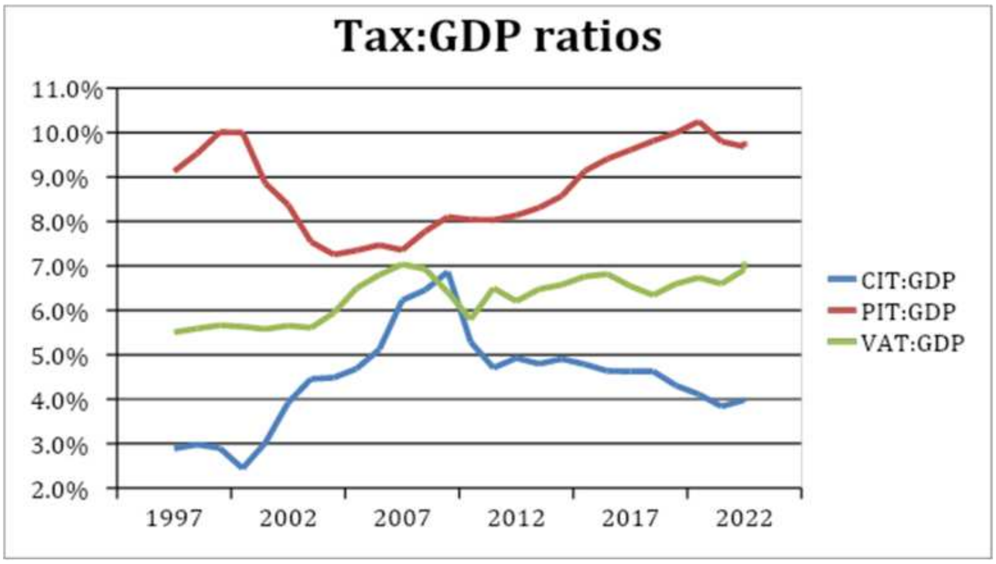
27. It is acknowledged that South Africa's high income and wealth inequality necessarily requires that its fiscal policy plays a crucial role in reducing inequality. South Africa does extremely well in this regard, with the largest reduction in inequality achieved by any of the countries studied to date 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*). It must, however, be pointed out that the World Bank has noted 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.

28. Although the above World Bank study was based on 2010 data and published in 2014, the effects of the pandemic have not changed the situation. Since 2010, South Africa's tax system has been made even more progressive as a result of significant tax increases in the period until 2019/20 and the manner in which they have been imposed. The result is that (again, notwithstanding the distortionary impact of the pandemic) South Africa's tax system and fiscal system as a whole are highly progressive.

Tax mix

29. In 2021/22, South Africa is forecast to obtain 38% (9.7% of GDP) of its tax revenues from personal income tax, 27.1% from VAT (6.9% of GDP) and 15.6% (4% of GDP) from corporate income tax.

30. Since the financial crisis of 2008, the individual contributions of each of the three main taxes to the tax mix has changed substantially. As is illustrated in the below graph, the contribution of personal income tax has increased substantially, the contribution of corporate income tax has decreased, while the contribution of VAT has remained relatively constant.



31. The significant drop off in corporate taxes following the financial crisis is evidence of the fact that corporate income tax revenues have come under severe pressure as a result of the poorly performing economy since 2009. This clearly supports the widely accepted principle that corporate income tax revenues are particularly susceptible to weak economic growth. This is of particular concern in the wake of the pandemic.

32. Regarding the upward trend in personal income tax, this is a clear result of substantial tax increases in the each of the five fiscal years until 2018/19. These increases were aimed at raising additional revenue, and included below-inflation increases in the tax brackets and rebates, as well as the introduction of a new top rate of 45% in 2017. These increases did not, however, translate into significantly increased revenue collections, largely as a result of their adverse effect on consumption and spending, and therefore economic growth. Moreover, these tax increases have had an adverse effect on levels of tax compliance. Accordingly, no increases in personal income tax were implemented in 2019/20 (when slight real personal income tax relief was given). Similarly, Budget 2021

has again included a higher-than-inflation adjustment to the personal income tax brackets, as well as an inflationary adjustment to the value of medical tax credits.

33. As noted in the Budget Review, notwithstanding the effects of the pandemic and even after the real personal income tax relief given in 2019/20 and 2020/21, South African income tax rates (i.e. the corporate income tax rate and personal income tax rates) are still relatively high compared to South Africa's peers, and the VAT rate is relatively low.

34. The over reliance of South Africa on income taxes (i.e. direct taxes) results in a number of disadvantages:

- Regarding corporate income tax, tax revenues are highly exposed to volatile corporate profits. In this regard, it is noteworthy that the higher-than-expected revenue collections for the final three months of the 2020 calendar year were partly driven by higher corporate tax revenues, which (in turn) were driven by a strong performance in the mining sector for that period due to favourable terms of trade in the form of high commodity prices and a weak currency. However, Budget 2021 also notes that, notwithstanding this strong performance, mining is still likely to contract overall for 2020, and that regulatory uncertainty, lack of investment and electricity shortages continue to hamper output. This underlines the risk arising from an over-reliance on corporate tax revenues.

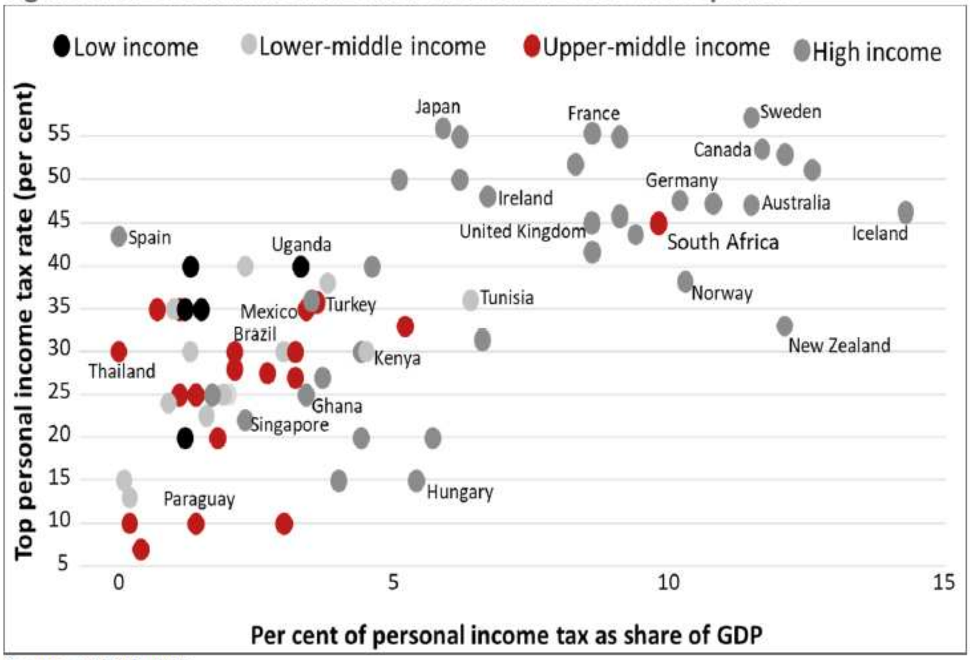
- Corporate taxes have been shown to have the greatest distortionary effect on economic growth. To illustrate this point, although corporate income tax is paid by a company, the burden of a high corporate tax rate is ultimately borne by three parties – the owners of capital (who have less to invest in the economy), labour (through lower wages) and consumers (through higher prices).

- 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.

- South Africa's relatively high corporate income tax rate creates an incentive for profit shifting to jurisdictions with lower tax rates, thereby affecting SARS' efficiency in administering CIT, and ultimately reducing revenue collections overall.

- Personal income taxes are collected from an increasingly small pool of taxpayers. It is estimated that just 25% of those who pay income tax pay 80% of all personal income tax that is collected. Over the past few years, a smaller proportion of taxpayers has become responsible for an increasingly large portion of total personal income tax payable. Regarding the relatively high personal income tax rate burden, this is illustrated by the following scatter plot provided in the 2021 Budget Review:

Figure 4.3 Personal income tax as a share of GDP and top rates



Source: OECD, IMF

- 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.
- In contrast, consumption taxes (such as VAT), because they do not distort savings and investment and are levied on a broader base, have been shown to be less damaging for economic growth. Similarly, 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. This means, essentially, that direct taxes reduce economic activity to a greater extent than indirect taxes, and therefore have more of a negative effect on economic growth than indirect taxes. Conversely, a decrease in direct taxes will have more of a positive effect on economic growth than a decrease in indirect taxes.
- It is also widely accepted that direct taxes serve as a disincentive to save and invest. Consequently, relief from direct tax (such as a reduction in personal income taxes) could result in an improvement in South Africa's 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 PIT relief should therefore assist in reducing the incentive to avoid and/or evade taxes by improving taxpayer morale.

35. The above having been stated, we are fully supportive of the policy to reduce the corporate income tax rate (and personal income tax rates) over the medium term through broadening the tax base in a revenue neutral manner, which will be done by broadening the income tax base. This will not only address the concerns outlined above, but also contribute to economic recovery and growth. In addition, measures announced to review or eliminate tax incentives and certain expenditure deductions, with a view to limiting favourable treatment of certain taxpayers and or groups of taxpayers, will enhance the overall progressivity of the tax system (notwithstanding the reduction in income tax rates) and we are supportive of this in general terms.

SACU

36. We note that Budget 2021 revises upwards payments to the Southern African Customs Union (SACU) by R1.9 billion in 2022/23 and R15.5 billion in 2023/24. As stated in the Budget review, this upward revision is mainly due to an improved GDP growth outlook, and better performances in customs, specific excise duties and *ad-valorem* excise duties.

37. In previous years, we have, in our submissions on the Budget to the Standing and Select Committees on Finance, drawn the attention of the Committees to the fact that the revenue sharing formulae (which determine the share of customs revenue between the members of SAU) 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.

38. In short, the BLNE countries have become heavily dependent on the SACU revenues to fund their fiscuses. The result is that South African taxpayers are effectively subsidising SACU member countries to a significant extent, and this puts a large strain on South Africa's fiscal position. We believe that a more equitable sharing of the customs revenue pool would see South Africa entitled to a greater, more equitable share of the pool. Given the fiscal crisis in which South Africa finds itself, it is difficult to justify South Africa's continued subsidisation of the BLNE countries to the extent that 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 more urgent than ever that the agreement be renegotiated in order to provide for a more equitable sharing of revenues.

B. Revenue proposals

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

General

40. Generally, we welcome and fully support the government's proposal to withdraw the tax increases previously announced in the June 2020 Special Adjustments Budget (and confirmed in the 2020 MTBPS) and to not introduce measures to increase tax revenues in the 2021 Budget. COVID-19 has led to many business closures and job losses, and tax increases would almost certainly put undue pressure on a struggling economy and undermine the chances of a stronger economic recovery. We are in full agreement with the statement in the Budget Review that there is no compelling case for increasing taxes at this time, and that income tax rates should be reduced over the medium term by expanding the tax base through stronger economic growth, employment and enforcement.

41. As was abundantly demonstrated by the effects of the significant personal income tax increases over the five year period ending in 2018/19, 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.

42. Furthermore, as indicated earlier in this submission, the structural fiscal deficit is a result of unsustainable expenditure growth rather than to low tax levels. Accordingly, the solution to fiscal consolidation does not lie in increasing taxation.

Personal Income Tax

43. For many of the reasons set out under our comments above relating to South Africa's tax mix, we welcome the relief provided to individuals by way of an above-inflation adjustment to the personal income tax brackets. As noted, the PIT burden is at record levels (10.2% of GDP in 2019/20) and this tax base is accordingly under severe pressure.

44. The relief provided in respect of PIT in this year's Budget will, by facilitating increased consumption and savings, have a direct stimulatory effect on economic growth, which is vital in order to increase overall tax revenues in the wake of the pandemic.

Company tax rates

45. In our comments to these Committees on the 2019 and 2020 Budgets, we welcomed the decision not to increase tax rates on companies in those years. As we have outlined above under our comments on South Africa's tax mix, we noted that South Africa's corporate income tax rate is relatively high by global standards and the CIT burden is amongst the highest in the world. We further drew attention to the fact that any increase in the tax rate would negatively impact the country's competitiveness and increase its susceptibility to base erosion and profit-shifting and noted that the global trend in corporate income tax rates is downward.

46. This is of particular import in the context of the damage done to South Africa's economy in the wake of the pandemic. We are therefore fully supportive of the proposal to reduce the corporate income tax rate with effect from 1 April 2022. It is most fortunate that the

effects of the pandemic have not resulted in government backtracking on its broad proposal in Budget 2020 to introduce measures aimed at restructuring the CIT system over the medium term by broadening the CIT base, enabling it to reduce the CIT rate in a revenue-neutral manner.

47. Again, as stated in the Budget Review, South Africa's relatively high CIT rate acts as a hindrance to economic growth by reducing its competitiveness. Although CIT is paid by companies, the burden of a high CIT rate is ultimately borne by three other parties – the owners of capital (who have less to invest in an economy that urgently requires investment), labour (through lower wages), and consumers (through higher prices).

48. As stated in the Budget Review, the approach of the government regarding the corporate income tax rate (as well as with PIT rates), takes account of the effect of higher taxes on economic growth, the behavioral responses of taxpayers to higher tax rates, inequality and fairness, and SARS' administrative capacity. This is conducive to broad-based economic growth by both facilitating economic growth and competitiveness and avoiding complicated incentives for specific sectors or groups of taxpayers.

49. In this regard, the following statement, which we support, regarding the maintenance of broad tax bases and low tax rates is made in a 2016 OECD working paper[1]:

> "*A tax system is considered efficient if, for any given amount of revenue to be raised, it distorts behaviour as little as possible. A base-broadening and rate-cutting reform should reduce distortions by reducing overall tax rates and removing incentives for taxpayers to change their behaviour to take advantage of tax reliefs. In considering the economic efficiency case for removing tax reliefs and broadening the tax base the underlying need for revenue neutral reform is crucial. When tax reliefs are given, tax rates have to be higher than otherwise.... There is thus a strong presumption (aside from cases where reliefs play a role in correcting externalities) that reforms that enable a reduction in tax rates will increase economic efficiency.*
>
> *Moreover, broad bases simplify the tax system by reducing exemptions, allowances, credits and/or rates differentiation. This simplification may reduce compliance costs related to individuals and businesses in terms of tracking tax-preferred activities, understanding qualifying and reporting requirements, time required to complete tax returns and to get the relief. At the same time, a broad base approach may reduce the administrative costs of defining the rules of preferential tax treatments, ensuring compliance with the rules (in terms of length of tax instructions and auditing time) or refund costs. Broader tax bases may also be more effective in terms of achieving higher levels of taxpayer compliance and reducing opportunities for tax avoidance, in turn enabling lower tax rates (for given revenue*

[1] Brys, B. et al. (2016), "Tax Design for Inclusive Economic Growth", OECD Taxation Working Papers, No. 26, OECD Publishing, Paris. http://dx.doi.org/10.1787/5jlv74ggk0g7-en; at pages 50 to 51.

needs) and improving horizontal equity. Tax bases could be broadened in particular by removing tax expenditures that are not well-targeted at redistributive goals."

50. Regarding the review of tax incentives, we are supportive of the overall, broad principle that it is preferable to have a lower CIT rate across a broad base than a higher rate across a narrow base with a large number of incentives. However, as was stated in our submission on the 2020 Budget, in the context of the complexities of commerce and industry, no principle should be blindly adopted as being absolute. Efficiency, flexibility and effectiveness dictate that there must always be exceptions to overall broad principles. There will always be a place in a sophisticated tax system for well-designed, appropriate and effective incentives. We therefore trust that any reviews of incentives will be conducted by the government in this light.

Increases in excise duties on alcohol and tobacco

51. One of the effects of the pandemic has been to highlight the effect of the abuse of alcohol on society as a whole, as well as the cost to the fiscus and the burden placed on the public health system of the abuse of alcohol and tobacco. While we are fully sympathetic to concerns relating to this abuse, we do not believe that the 8% increase in excise duties on alcohol and tobacco products proposed in Budget 2021 is appropriate in the current context.

52. The alcohol and tobacco industries have suffered severely following lengthy sales bans implemented over the past year. It is notable that, as is stated in the Budget Review, specific excise duties are expected to fall by nearly 50% as a result of these bans. Possible further bans in 2021 would have a further adverse effect on these industries, and would interrupt revenues from these sources.

53. In addition, the sales bans have contributed to the development of both new and existing black-market networks, particularly in the case of tobacco. Increasing excise duties can only have the effect of further entrenching these black-market networks, which will ultimately be to the detriment of both the fiscus and society as a whole.

54. Compounding the predicament in which entities operating in the alcohol and tobacco industries find themselves is the announcement, in the Budget, that the policy framework for the both alcohol and tobacco will be reviewed during 2021/22. No specifics are provided in this regard, and this creates unneeded additional uncertainty for these industries, which are under severe strain as a result of the pandemic and the numerous sales bans implemented over the past year.

55. Again, although we are sensitive to the concerns arising from the abuse of alcohol and tobacco, given the current circumstances, we are of the view that it would have been preferable to postpone any increases in the applicable excise duties pending the outcome of the announced review. To introduce such substantial tax increases before conducting the review means that policy decisions are being made in a vacuum without understanding the potential implications, negative or positive, including health and

welfare benefits, the impact on employment and illicit trade and other potential policy interventions.

56. We accordingly warn that the increases may have unintended consequences and urge government to conduct a comprehensive review before implementing such dramatic tax increases.

Rebuilding the South African Revenue Service

57. We note the commitments made in the Budget Review with respect to the rebuilding of SARS, and particularly the additional spending allocation of R3 billion to SARS to modernise its technology infrastructure and systems, expand and improve the use of data analytics and artificial intelligence capabilities, and participate meaningfully in global tax compliance initiatives.

58. We are fully supportive of these renewed commitments to enforcement and administration, which will go a long way to addressing South Africa's substantial tax gap, which is estimated at approximately R200 billion. Addressing this tax gap will, in turn, be critical in further broadening South Africa's tax base, which will further facilitate efforts to reduce tax rates, thereby enhancing economic recovery and growth.

59. Regarding the tax gap alluded to above, we note that the Davis Tax Committee has issued a report to the Minister of Finance relating thereto. It is not clear why there has been a delay in making this report public, and (in the interests of transparency) we urge this be done as soon as possible.

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,

Kyle Mandy
Tax Policy Leader
kyle.mandy@pwc.com
+27 (11) 797 49 77

Greg Smith
Senior Manager: Tax Policy
greg.smith@pwc.com
+27 (11) 797 4588