National Treasury T16/05

The VAT treatment of merit goods and services

March 2011 (October 2007)

The brief

The Terms of Reference indicated that National Treasury required a review of current and proposed VAT exceptions and guidance on how to treat future requests for preferential treatment of so-called merit goods and services.

The key objectives of the study are to:

Develop a sound tax policy position with regard to the VAT treatment of merit goods and services in general;

Review whether existing merit goods or services treated as exceptions are in line with sound tax policy principles;

Develop a sound tax policy position with regards to the VAT treatment of books, medicines, medical services and municipal services (electricity and water);

Analyse the appropriateness and effectiveness of the existing and proposed VAT relief measures and the distributional implications of the suggested merit goods or services; and

- Ensure protection of the tax base but at the same time ensuring that the VAT system is equitable acceptable, and administratively not too complex.

The brief (cont.)

To achieve this, the study team was required to consider:

- International trends and best practice;
- The views of various stakeholders;
- The likely economic impact of existing and proposed exceptions;
- The anticipated fiscal impact of existing and proposed exceptions;
- The administrative implications of changes to the status quo.

Key questions to answer

- Whether international experience with VAT warrants a fundamental change in the view of VAT as a broad-based consumption tax with minimal exceptions?
- Whether new arguments have been put forward (or new products identified) that justify a change to the VAT treatment of specific goods and services?
- Whether social and economic conditions in South Africa have changed sufficiently since VAT was introduced to warrant a different VAT treatment for certain identified merit goods and services?
- What will the impact of changes to the existing VAT dispensation would be on tax collections and the required changes to the VAT rate?
- Whether administrative and other systems technologies have changed to such an extent that the compliance costs associated with changes to the current dispensation would no longer mitigate against the adoption of such changes?

Definition of merit goods and services

Arguments used to justify merit status include:

- The good or service is in the public interest;
- The product is essential;
- Poorer households should not have to pay VAT on these products;
- Targeted budgetary assistance is not capable of ensuring that the product can be supplied to everyone;
- The product is of a cultural nature;
- The product is of an educational nature and taxation amounts to a tax on knowledge; or
- The product is hard to tax.

In practice, merit goods have come to include all products for which exceptions have been adopted or are being considered.

International treatment of merit goods

The majority of countries studied afford some form of preferential VAT treatment to the existing and/or proposed merit goods and services in South Africa.

Preferential treatment can take the form of zero-rating, exemption or a lower rate.

The VAT rates in many other countries are higher than in South Africa.

The scope of VAT relief is often limited, e.g. to services provide by state-owned or non-profit organisations.

Educational services are generally regarded as meriting preferential treatment in all regions of the world. Preferential treatment is usually in the form of an exemption.

Lower rates tend to be applied to reading matter more frequently than exemption or zero-rating.

International trends - conclusions

- VAT relief of merit goods or services should be viewed against the background of generally higher VAT rates.
- VAT concessions typically only reduce the regressivity of the VAT system when the spending patterns of lower income groups are viewed in isolation.
- VAT concessions that cannot be targeted to poorer households actually make VAT more regressive.
- VAT concessions undermine the attainment of other tax objectives (i.e. neutrality, efficiency and simplicity) and could distort consumer and producer choices.

Policy considerations and concessions (1991)

Introduction of VAT in 1991 was against the backdrop of the Government of the day with a different political dispensation and economic climate.

The main reasons to replace the GST system were the unpopularity of the tax, the extent of evasion and the narrow base.

Though VATCOM recommended that the VAT system should be implemented without any concessions or relief measures, various representations and political pressure resulted in changes to the draft legislation.

The concessions included:

- a lower VAT rate from 12% to 10%;
- exemption of pre-primary, primary, secondary, and tertiary educational services and incidental supplies;
- zero-rating of basic foodstuffs;
- standard rating of medical services; and
- exempting of municipal rates and services.

Views of stakeholders

- Little in the way of new arguments to support claim of merit status.
- No proposals for changes to existing zero-ratings and exemptions.
- Clear preference for zero-rating over exemption.
- No request for introduction of additional rates.
- Some appreciation of the complexity associated with mixed supply that includes exemptions.
- No suggestions for alternative sources of tax revenue to replace foregone VAT.
- No quantification of compliance costs but assumed to be small if change is to zero-rating.
- Workable definitions of qualifying books and medicines but potentially discriminatory and could create barriers to entry.

Analysis of household spending

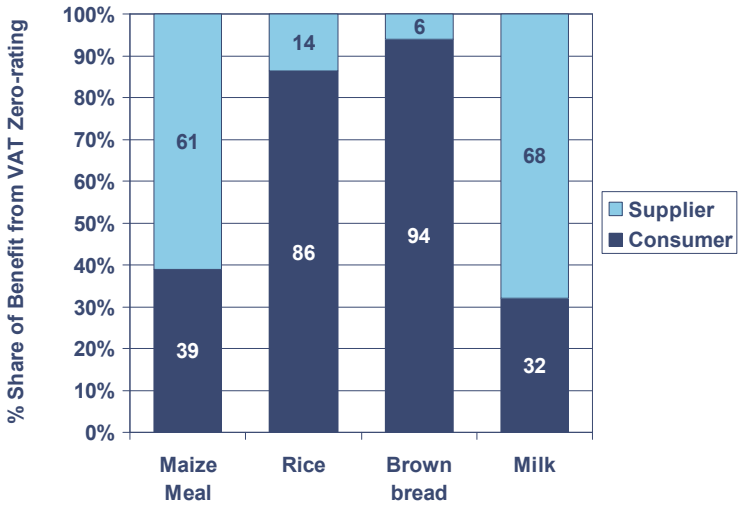
Existing zero-ratings do tend to make up a higher proportion of the consumption spending of lower income households.

However, when these expenditures are considered in the context of total household consumption spending, they tend to account for a much smaller portion of total spending.

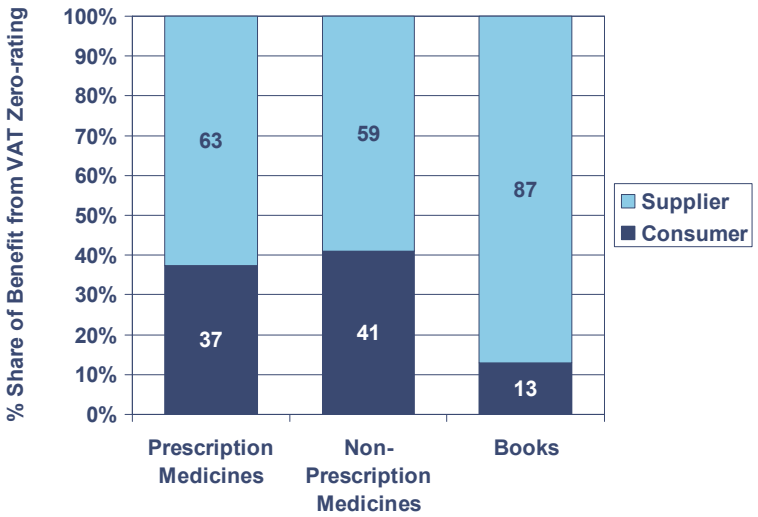
As a result, the VAT “savings” enjoyed by lower income groups are much lower than those enjoyed by higher income groups.

The only products where current favourable VAT treatment leads to some reduction in regressivity are mealie meal and bread flour.

Estimated proportion of benefits from zero-rating accruing to consumers and suppliers



Estimated proportion of benefits from proposed zero-rating accruing to consumers and suppliers



Conclusions

"Very Low" and "Low" expenditure groups derive limited benefit from preferential VAT treatment. Targeted assistance, in the form of grants or subsidies, are required for assistance to reach these groups.

Existing zero-ratings and exemptions serve to make VAT system more regressive.

Excluding income and substitution effects, scrapping of the existing zero-ratings and exemptions studied could finance an increase in social grants of around 10%.

Suppliers of maize meal and fresh milk benefit more from zero-rating than consumers. Consumers benefit more than suppliers in the case of rice and brown bread.

Conclusions (continued)

Suppliers of books and both prescription and non-prescription medicines would benefit more from zero-rating than consumers.

Rising real incomes are likely to play a more significant role in facilitating increased consumption of meritorious goods and services than changes to their VAT treatment.

Based on comparative price increases, there is no consistent evidence to suggest that existing zero-ratings have been exploited by suppliers, but benefits of preferential treatment could have been eroded under GST.

Estimated value of VAT collections and concessions in 2006 - standard rated goods

Product	Estimated Value of Spending by Households in 2006	Estimated Value of VAT Collected in 2006
	(Rm)	(Rm)
Water	13,044.50	1,602.00
Electricity	15,037.50	1,846.70
Medicines with prescription	321.7	39.50
Health services not covered by medical aid	150.1	18.40
Medicines without prescription	35	4.30
Flat fee medical services	18.7	2.30
Doctors and dentists	1,708.60	209.80
Non-medical aid medicines with prescription	485.7	59.60
Non-medical aid medicines without prescription	316.6	38.90
"Text" books	2,188.10	268.70
Newspapers	1,159.60	142.40
Magazines	227.7	28.00
"Other" books	763.9	93.80

Some aspects of the fiscal analysis

Significant difference between the current VAT portion collected/foregone and the actual loss to the fiscus.

VAT "savings" are spent on other products – most of which would be standard-rated – due to income and substitution effects.

Final VAT losses or gains to the fiscus should approach the "VAT leakage" share of the VAT portion of current spending.

Has significant implications for the adjustments required to other taxes to maintain overall tax neutrality.

Conclusions

VAT concessions will:

- Normally reduce regressivity if the expenditure patterns of the poor are viewed in isolation.
- Provide some relief to the poor, but affect other policy considerations of equity, neutrality, efficiency and simplicity.

Conclusions

Problems of defining the scope of further concessions, drafting amendments and regulating the procedural and documentary requirements for applying a new zero-rating, exemption or lower VAT rate would be significant to SARS.

Vendors would require clarity as to how concessions would impact on them before proceeding with systems changes.

Technological developments in the IT arena have made it easier for businesses to change systems than was the case when VAT was first introduced. However, many small and medium-sized businesses have not adopted such IT.

Zero-rating of proposed new merit goods would carry a lower compliance cost than exemption or lower rate of VAT.

Broad philosophy

A VAT system with the smallest number of exemptions, zero-ratings and lower rates is desirable. Efficiency and simplicity considerations should dominate and equity and other objectives should be pursued through the expenditure side of fiscal policy.

In principle, the adoption, or perpetuation, of VAT concessions aimed at addressing regressivity should not occur unless ways can be found to target such benefits only to lower income households.

Existing zero-ratings and exemptions

Scrapping of existing zero-ratings (with exception of maize meal, bread flour, mealie rice) and exemptions (apart from hard-to-tax items)

- Phased in with explicit linked increases in social pensions and grants; or
- “Big Bang” accompanied by adoption of a basic income grant or something similar.

If they are not scrapped, existing exemptions could be converted to lower rates (7 to 8%) that allow full input VAT to be claimed.

Proposed merit goods and services

Rejection of requests for merit good status in the case of :

Books because -

- it will worsen the regressivity of VAT;
- the cost of books has little influence on literacy levels in South Africa;
- additional funding for books in the education system would have a bigger impact on literacy levels; and
- consumers are likely to receive a relatively small portion of any benefit arising from zero-rating

Medicines because -

- it will worsen the regressivity of VAT even though consumers might enjoy a significant portion of any VAT savings;
- the positive price elasticity of demand suggests that elimination of VAT from medicines would not have the desired effect of increasing consumption of medicines; and
- Very Low and Low expenditure groups are in any case reliant on the public health sector for access to medicines. Lower medicine costs would not automatically improve access to health care of these groups.