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Standing Committee on Finance
Parliament of the Republic of South Africa
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Chair, Members,

# Budget 2015 Fiscal Framework and Revenue Proposals – Preliminary Comment

1. We present herewith our initial commentary on the Tax Proposals included in the 2015 Budget Review.

2. As always, we remind members that tax legislation is notorious for having the proverbial "devil in the detail". As such, we may remain silent in respect of certain proposals that subsequently turn out to be objectionable or laudable, or we may commend ones that end up less favourable than initially anticipated, or we may oppose some that perhaps turn out to be less harsh than expected. We therefore eagerly await the actual text of draft legislation before submitting more comprehensive comment.

## A. Overall

3. There is little doubt that the 2015 Budget was the toughest since the advent of democracy. The Minister faced difficult choices and fiscal consolidation was essential in order to reduce the risk of further credit rating downgrades. Given the slow economic growth and the need to reduce the budget deficit, he could either have increased taxes or trimmed government expenditure. Ultimately, he has done both. We comment on this in more detail below.

4. The stubbornly high budget deficit remains a concern. It continues to hover around the levels it was at in 2010/11 and it is estimated to continue to be at 3.9% of GDP in 2015/16. It is worrying that the trend of kicking the proverbial can down the road in decisively reducing the budget deficit seemingly continues, despite the indication in the medium term budget policy statement that the deficit would be reduced to 3.6% of GDP

in 2015/16 (and that on lower GDP numbers prior to the rebasing thereof) and despite the structural increases in tax revenues that have been proposed in this budget. The budget deficit should be more decisively and aggressively reduced.

5. On a more positive note, it is encouraging to see that we are now budgeted to fund current expenditure out of current revenues and that debt is to be used to fund capital expenditure in 2015/16.

6. In our view, the real issue that needs to be decisively addressed is expenditure growth. In the context of fiscal consolidation, it is therefore concerning that real growth in main budget non-interest expenditure of 2.5% has been budgeted for 2015/16. While the R10 billion reduction in the expenditure ceiling is to be welcomed, more should and could be done to reduce government expenditure. Were expenditure growth to be limited to a nominal 6.4% as opposed to the nominal 7.4% in the budget this would reduce government expenditure by a further R10 billion or approximately 0.25% of GDP. We submit that this is entirely reasonable and achievable.

7. The above needs to be considered in the light of structural increases in taxation for 2015/16 of R23 billion comprised mainly of R9.4 billion in personal income tax, R4.3 billion in the general fuel levy and about R9.2 billion in the RAF levy. While this has been offset to some extent by a reduction in UIF contributions of R15 billion, we note that this is a temporary measure.

8. It is important that government carries its fair share of the fiscal consolidation burden, which, in our view, is not the case in this budget.

9. A further concern is the considerable downside risk to the expenditure estimates associated with the wage bill. If wage settlements are significantly in excess of the budgeted increases this would put the expenditure ceiling and budgeted deficit at risk.

10. The remainder of this submission is focused on the revenue proposals and the tax proposals in particular.

## B. Proposals that are welcomed

11. We set out below our comments on the proposals that are welcomed. Note, however, that although many of these are generally welcomed, in some instances we do also have some concerns.

### Individuals

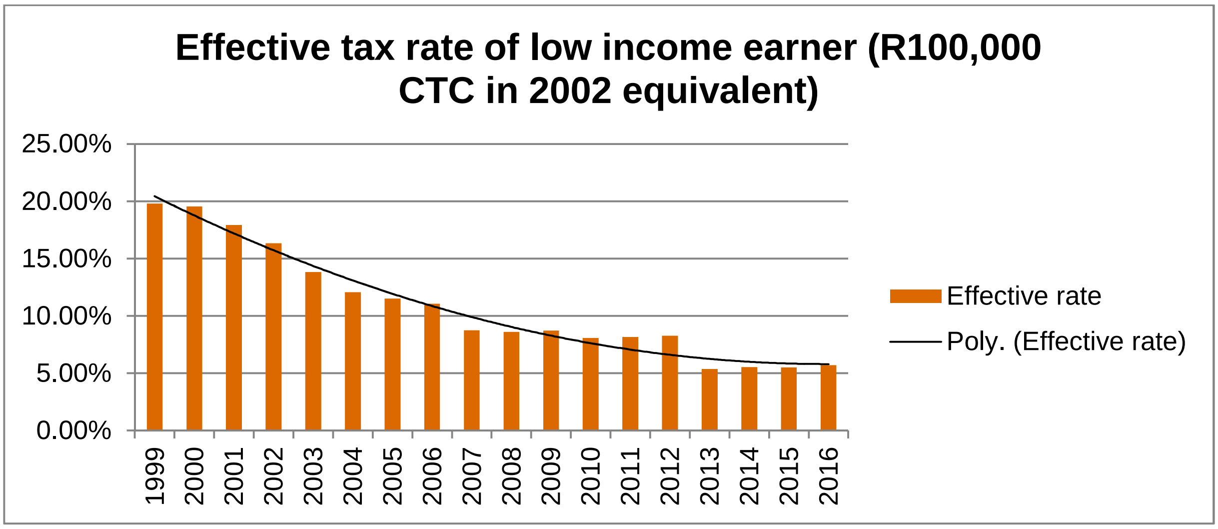
*Personal income tax relief*

12. We welcome the tax relief provided to lower income earners and the fact that they have been cushioned to some extent from tax increases. However, we note that real relief is limited to those earning less than about R150,000 per year. The impact on a person earning approximately R200,000 a year is illustrated by the below graph showing real effective tax rates over time. The effective tax rate for such a person will increase slightly

in 2015/16. These persons will also be impacted by an increase in the general fuel levy and RAF levy which will more than offset the PIT tax relief that has been provided.

13. The clear picture is that the middle class will still be significantly impacted by the structural tax increases, while higher-income earners will be affected to an even greater extent with most of the burden falling on them.

14. We have some concerns with the structural increase in PIT which are elaborated on below.




*Retirement savings*

15. We welcome the announcement that the harmonisation of the treatment of retirement funds will be implemented from 1 March 2016, having been disappointed with the last minute postponement thereof in 2014.

16. We also welcome the proposal to close loopholes related to the estate duty treatment of retirement funds. We do, however, caution that care would need to be taken that only those instances of abuse are captured by the proposal to subject non-deductible contributions to estate duty and that normal non-deductible contributions are not inadvertently caught, e.g. member contributions to provident funds or monthly RAF contributions.

**Business**

*Company tax rates*

17. We welcome the decision not to increase the tax rates on companies, neither in respect of profits nor in respect of dividends.

*Relief for small business*

18. We welcome the relief proposed for micro businesses in the form of reductions in the rates of the turnover tax. This should go some way to making the regime more attractive.

19. However, further reforms should also be considered, e.g. in relation to an increase in the R1 million threshold which has been at this level for a number of years.

*Energy-efficiency savings incentives*

20. We welcome the proposal to increase the incentive to 95c/kWh and to extend it to cogeneration projects. We note, however, that the incentive is only viable for large scale projects and its benefits are eroded substantially by the fact that it applies only for the year in which the energy-efficiency savings are realised. When the incentive was first mooted, the principle was that income taxes would not be payable on the energy cost savings derived from such projects. That principle was watered down substantially with the final incentive.

*Transfer pricing*

21. Although the reference to improving transfer pricing documentation is rather cryptic, we assume that this relates to the introduction of compulsory transfer pricing documentation and country-by-country reporting as proposed in the BEPS project. Assuming that is the case, we welcome this development, subject to the threshold for compliance not being set too low so as to place a significant compliance burden on smaller multinationals.

*Research and development*

22. We welcome the proposal to address the problems for taxpayers associated with delays in the adjudication process and look forward to a workable solution.

**Indirect tax**

*Fuel taxes*

23. Given the choices faced by the Minister in identifying a source for the additional tax revenues required for fiscal consolidation, we applaud the decision to increase fuel taxes as having the least damaging impact on long-term economic growth. We do, however, question if there was perhaps scope to increase the general fuel levy more than has been proposed and reduce the more damaging effects of an increase in personal income taxes.

**Tax administration**

*Self-assessment system*

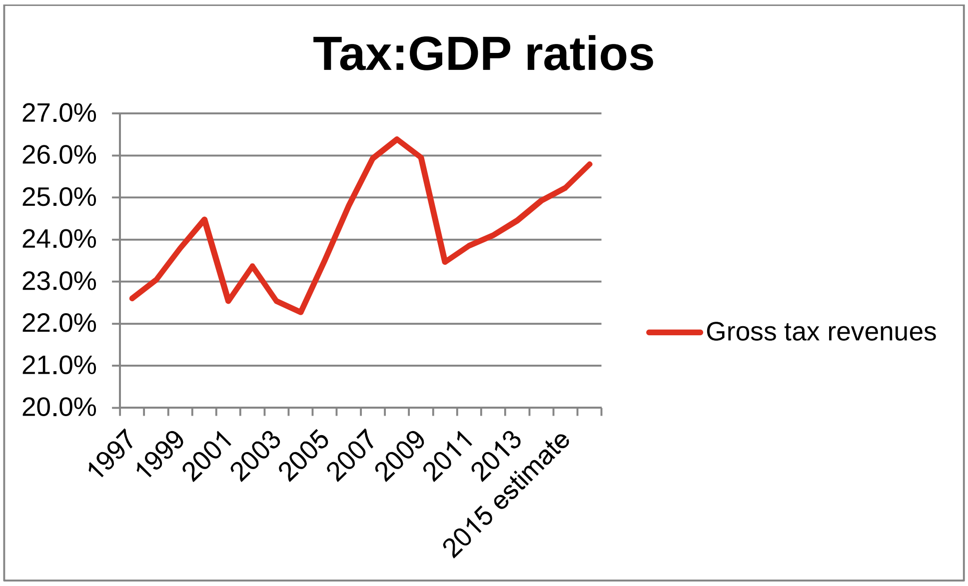
24. We welcome the indication that a move to a self-assessment system for income tax is imminent. The self-assessment system is crucial to reducing the tax burden on companies, particularly small and medium enterprises.

## C. Areas of Concern

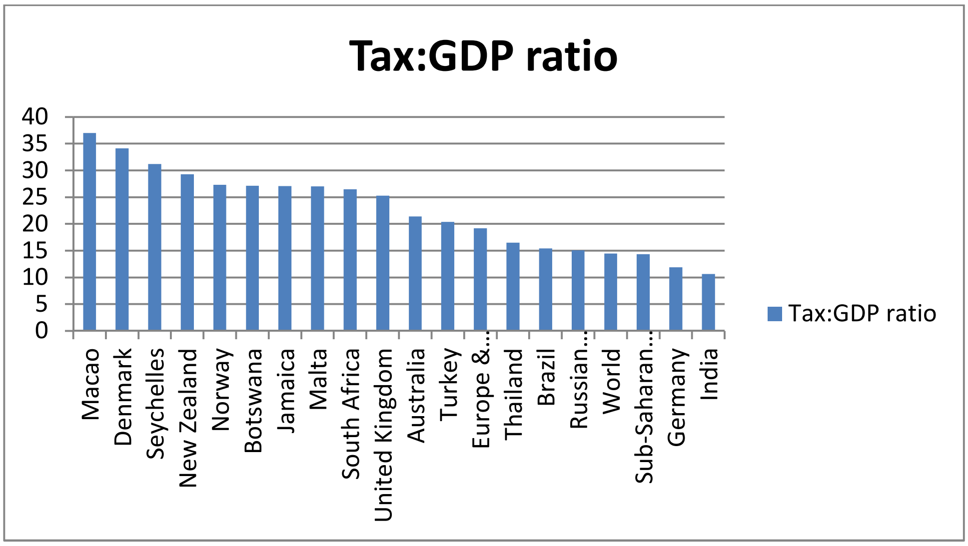
### General

*Level of taxation*

25. The level of taxation in South Africa has been steadily growing since 2004 when the main budget tax revenues stood at 22.3% of GDP. It reached a peak of 26.4% in 2008 before falling substantially in the wake of the global financial crisis. However, it has since recovered to similar levels with the level of taxation estimated to be 25.8% of GDP for 2015/16, increasing further to 26.2% by 2017/18. The below graph illustrates the level of taxation from 1996/97 to 2015/16.




26. Of concern is that, according to World Bank Group data, South Africa had the ninth highest tax:GDP ratio of all countries (excluding social security contributions) for 2012 (in fact South Africa would rank eighth if Botswana, whose tax revenues consists substantially of SACU revenues derived from South Africa, was excluded and even higher if other exceptional jurisdictions such as Macao are excluded). South Africa's tax:GDP ratio is significantly higher than the world and Africa averages as well as most middle income countries. The below graph illustrates the nine countries with the highest tax:GDP ratios, world and regional averages and a selection of other middle income and BRIC countries.




27. It is clear that South Africa has a high tax burden by international standards. While some of this tax burden is explained by a large social security system funded out of general tax revenues rather than social security taxes, if the tax burden was reduced by social security expenditure, South Africa would still have a relatively high tax burden.

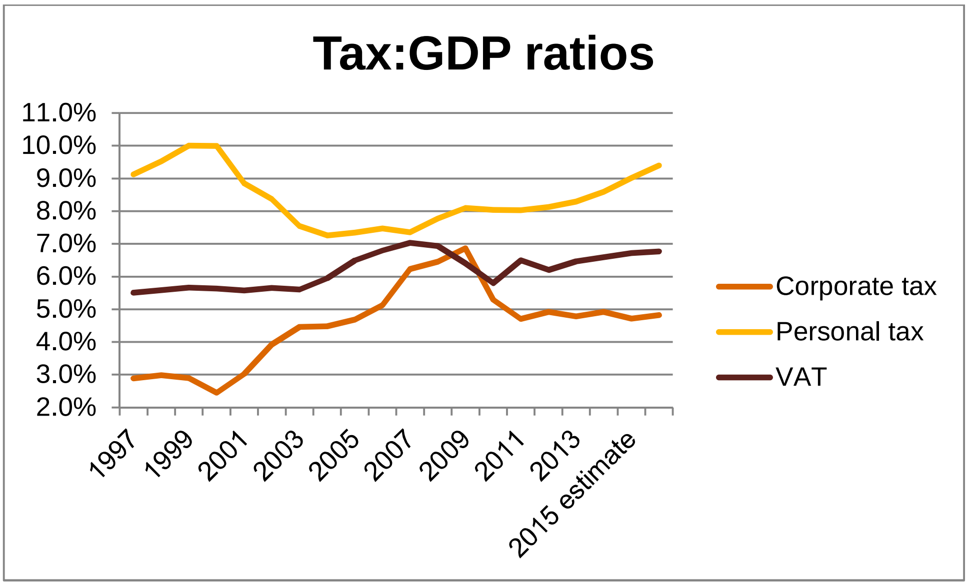
28. It is acknowledged that South Africa's high income and wealth inequality necessitates its fiscal policy to play a crucial role in reducing inequality and South Africa does extremely well in this regard with the largest reduction in inequality achieved by any of the countries studied at this stage.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

29. However, if South Africa is to rely on the private sector to be the primary driver of economic growth and employment, it is going to have to reduce the tax burden over time in order to free up resources for investment by the private sector. This is not, however, as critical as ensuring that our tax mix is conducive to economic growth.

*Tax mix*

30. South Africa obtains approximately 35% (9% of GDP) of its tax revenues from personal income tax, 27% from VAT (7% of GDP) and 20% (5% of GDP) from corporate income tax. 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% of tax revenues and 7% of GDP in 2008/9. Over the same period, the contribution of personal income tax fell significantly while that of VAT stayed relatively consistent.

31. 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.




32. 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. The result is that South Africa has become overly reliant on corporate income tax while the tax burden on individuals has returned to the levels it was at in the early 2000's. This results in a number of disadvantages:

- Tax revenues are now more highly exposed to volatile corporate profits, as was illustrated in the wake of the 2008 global financial crisis. This resulted in a significant dip in corporate taxes in 2009/10 to less than 5% of GDP while the recovery has been slow in light of continued global and domestic challenges. This slow recovery of corporate taxes is the primary reason why South Africa continues to incur a large fiscal deficit.

- 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.

- High income taxes result in lower levels of savings. These in turn translate into lower levels of investment or a greater need to fund investment with foreign portfolio flows, impacting on the value of the currency and the cost of debt.

- By contrast, lower consumption taxes result in greater consumption, resulting in lower savings levels, negatively impacting the current account balance and leading to unsustainable consumption-led growth.

33. The 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.

34. The OECD average for corporate tax revenues is 3% of GDP and 12% of tax revenues, personal income tax 8.5% of GDP and 33% of tax revenues and consumption taxes 7% of GDP and 28% of tax revenues. Given the above, South Africa's tax mix is in need of structural reform in order to reduce reliance on volatile corporate taxes (and to a more limited extent personal income taxes) and increase reliance on more stable consumption taxes in order to make the tax system more conducive to sustainable investment-led economic growth.

35. It is acknowledged that such a shift would make the tax system less progressive and increase the tax burden on the poor. However, if accompanied by appropriate social security reform to alleviate the burden of increased consumption taxes for the poor and preserve the overall progressivity of fiscal policy as a whole for the poorest, the positive impact of such reform over the medium term in the form of greater economic growth and employment could outweigh the negative implications of a slightly less progressive fiscal policy in the short term.

**Individuals**

*Structural increase in PIT*

36. The Budget introduced a structural increase in PIT of R9.4 billion through a 1% increase in tax rates at all income levels with the exception of the lowest. While it is acknowledged that the primary objective was to maintain the overall progressivity of the tax system and share the burden of tax increases between direct and indirect taxes, we have some concerns with the approach that has been adopted.

37. Firstly, direct taxes are more damaging to long-term economic growth than consumption taxes, such as VAT and fuel levies. The structural increase in PIT will have the effect of reducing discretionary income available for consumption or savings. It is the latter which is of primary concern as savings are crucial to long-term investment led growth. South Africa already has an extremely low level of household savings and the tax increases impact directly on those taxpayers that have the capacity to save. As the tendency is to reduce savings before reducing consumption, the result is likely to be decreased savings levels with consequential negative implications for economic growth.

38. Secondly, we are concerned with the manner in which the structural increases in PIT are proposed to be implemented through the 1% increase in the tax rate. Unfortunately, this will have a significant economic distortionary effect. It will increase the differential between effective corporate tax rates after dividends and PIT rates to 2.2%. This will significantly increase the incentive for persons to hold their investments and businesses through companies rather than holding them directly. Accordingly, it may be necessary to reintroduce the concept of a passive holding company which was scrapped when

dividends tax rates were introduced at 15% instead of 10% and increased effective tax rates on company profits to close to the maximum marginal rate. This will add unnecessarily complexity to our tax legislation. The higher PIT rate is also a disincentive to work and entrepreneurship, something that is crucial to economic growth.

39. We submit that the objectives of maintaining the overall progressivity of the tax system and generating the desired structural increase in PIT can be achieved without increasing the tax rate. This can be done by, instead of increasing and broadening all the tax bands to provide relief for fiscal drag, by limiting fiscal drag relief to the lowest tax bracket while lowering the other tax bracket thresholds to achieve the desired sharing of the additional tax burden. This would minimise the distortionary effects of the structural tax increase.

*Transfer duties*

40. While the proposal to reduce transfer duties on properties of up to R2.25 million is welcome and will provide some relief to the lower end of the property market, we are concerned with the significant increase in the transfer duty rate to 11% on properties in excess of this value. Transfer duty is a highly distortive tax and a significant impediment to an efficient property market. The increase is likely to have a significant impact on the property market for properties valued between R3 million and R5 million, a significant segment of the market that caters to higher-income earners, but not the wealthy.

41. Unfortunately, the increased taxes in this segment of the market may be offset by lower volumes and/or values of transactions with a consequential impact on transfer duty revenues. The tax rate increase is therefore, in our view, ill-advised. Unfortunately, the Budget Review provides no explanation for the proposed increase, but if it is assumed that the intention is to shift the tax burden of transfer duties to wealthier taxpayers, this could be better achieved in a far less distortionary manner by introducing a super tax rate for high end properties with a value in excess of, say, R10 million or R15 million.

**Business**

*Withdrawal of foreign tax credits SA-sourced service fees*

42. We are concerned with the proposed wholesale withdrawal of these credits. While the concern is acknowledged as being valid, there are two elements to these credits. The first is in relation to countries with which SA has concluded a double tax treaty. It is this element that gives rise to the concern expressed in the Budget Review. However, the second element relates to service provided to countries with which SA has not concluded a tax treaty. To withdraw the relief in relation to the second element will result in double taxation.

43. Unfortunately, the wholesale withdrawal of the credit will make South Africa less attractive as the gateway to Africa as a result of the potential for double taxation. Accordingly, the proposed withdrawal should be subject to further consultation.

**Indirect tax**

*RAF levies*

44. We note with some concern the very significant proposed 50c increase in the RAF levy.

45. While the RAF is insolvent and it is acknowledged that its deficit needs to be attended to, we submit that a more creative and innovative solution is needed to address the deficit in the medium term. As acknowledged in the Budget Review, such increases in RAF levies will do no more than put the proverbial finger in the dyke.

46. We note that the Budget Review indicates that legislation for the no-fault system is to be introduced during the year and seemingly implemented from 2016/17. We welcome this development. We not also the stated intention that the accumulated liability will be paid down over time.

47. We note that the Unemployment Insurance Fund has net assets in excess of the net liabilities of the RAF. We would suggest that this presents an opportunity to utilise the UIF surplus to clear the RAF deficit as part of the transition to the no-fault system and in anticipation of social security reform.

48. There is no better example of the fallacy of ring-fenced taxes than that demonstrated by the relative situations of the UIF and RAF.

*Electricity levies*

49. We note with concern the proposal to increase electricity levies by 2c/kWh as a temporary measure to manage demand for electricity. The increased electricity levy is likely to have little impact on demand. The levy increase is relatively small in relation to the price of electricity and much of the energy-efficiency gains have been achieved over the last few years as a result of the significant electricity price increases. As such, the increase in the levy is likely to simply burden users with further increased electricity costs while doing little to reduce demand. This is something the economy can ill-afford at this stage.

50. Although it is noted that it is proposed that the additional revenue will be used to fund the additional benefits under the energy-efficiency incentive, we question whether this will actually be the case. Government has a poor track record in recycling the revenues from the electricity levy despite the stated intention to do so. We remind the Committee that when the levy was increase by 1c/kWh in 2012 this was intended to replace the demand side management programme that was funded out of electricity tariffs. Since then, the demand side management programme has been suspended and there is little evidence of the revenues being used for their stated purpose.

*Carbon tax*

51. We are disappointed that government seems determined to press ahead with the introduction of the carbon tax in 2016. We have previously vigorously expressed our

concerns regarding the introduction of carbon pricing in South Africa at this time and we reiterate these below –

- The timing of its introduction prior to binding global commitments to mitigation and funding as recognised by the National Development Plan (NDP) where it is stated that mitigation actions would need to take place in the context of an agreed international framework for mitigation;
- Placing South Africa at a competitive disadvantage to other countries that do not have a price on carbon;
- Whether a carbon tax is the appropriate mitigation instrument for all sectors and sub-sectors of the economy, notably the energy sector, and electricity in particular, where the NDP suggests that the Integrated Resource Plan should be the primary mitigation instrument in the short to medium term;
- The relatively high price on carbon proposed in relation to international prices; and
- The lack of detail on how the tax will be kept revenue neutral through tax shifting or tax revenues recycled through related expenditure programmes.

52. The state of the economy has deteriorated further over the last year and growth for the next few years is expected to be muted. Introducing a carbon tax at this stage will further damage economic growth and is likely to lead to job losses.

53. We urge that the Minister urgently refers the proposed carbon tax to the Davis Tax Committee for their consideration and recommendations ahead of any policy decision being taken to implement the tax.

*SACU*

54. 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 formulas:
    - 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.

55. Unfortunately, the revenue sharing formula is weighted heavily against South Africa. Of particular concern is the formula for sharing customs duties. South Africa has significant trade surpluses with all other member countries. In 2014, SACU exports from South Africa amounted to R132 billion, while imports amounted to only R28 billion. The result of these significant trade surpluses is that the bulk of customs duties in the combined

revenue pool accrue to the other members, 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.

56. 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.

57. More importantly, the tax increases being sought in the 2015 Budget would not be necessary were the SACU revenue sharing formula to provide for a more equitable sharing of the revenues. The BLNS countries have now become heavily dependent on the SACU revenues. The result is that South African taxpayers are funding SACU member countries to a significant extent. The below table illustrates how dependent the BLNS countries have become on SACU revenues, the strength of their fiscal positions are and how they compete favourably with South Africa on tax rates (Namibia is the exception).

| | **Botswana** | **Lesotho** | **Namibia** | **Swaziland** |
|---|---|---|---|---|
| **SACU revenue reliance** | 30% | 44% | 35% | 50% |
| **Budget balance** | Surplus | Surplus | Large deficit | Small deficit |
| **Corporate tax rates** | 22% (manufacturing/IFSC 15%) | 25% (manufacturing 10%) | 32% (manufacturing 18%) | 27.5% |
| **PIT top rate** | 25% | 30% | 37% | 33% |
| **VAT rate** | 12% | 14% | 15% | 14% |

The South African taxpayer is no longer in a position to be able to afford to subsidise the BLNS countries to the extent that it is currently doing. While the fiscal stability of these countries must obviously be taken into consideration in order not to destabilise the region, the agreement should be renegotiated over the medium term in order to provide for a more equitable sharing of revenues, failing which South Africa should withdraw from the agreement.

We thank you for the opportunity to offer our opinion on the Budget fiscal frameworks 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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