Sanlam

Economic Overview for Business Owners

March 2017

The tax structure should be aligned with the growth objective

Attention has been keenly focused on adjustments to the tax regime in this year's National Budget, read by Minister Gordhan in February 2017, as the National Treasury followed through on its stated intent to raise an additional R28 billion from taxpayers in the current fiscal year.

Justifiably, the Minister leaned towards pursuing equity in the tax system by introducing a new top marginal tax bracket and increasing the top marginal tax rate to 45% from 41%. In addition, to promote "horizontal equity" the Treasury increased the dividends withholding tax rate from 15% to 20% (projected to raise an additional R6.8 billion in revenue) in order to reduce the gap between the top marginal income tax rate for individuals and the combined statutory tax rate on dividends[1].

However, whereas the introduction of the new top marginal tax bracket and tax rate is expected to add R4.4 billion to national tax revenue, the bulk of taxpayers will be hit as the Minister nets a further R12.1 billion by only partially compensating for fiscal drag in the amount of R2.5 billion. Full relief through the adjustment of tax brackets would have amounted to R14.6 billion.

Indirect taxes, including the usual sin tax increases and the adjustments to the fuel and RAF levies, net the Treasury a further R5.1 billion, but overall tax increases are skewed towards direct taxes and taxes on income earned from savings, rather than indirect taxes.

These changes are not optimal from the perspective of supporting growth. The dividend withholding tax lowers the return on savings, which is not ideal considering South Africa's dearth of savings to fund investment, while increased taxes on income lower the incentive to work.

A better option would have been to increase the VAT rate. A 1% increase in VAT could have raised most of the extra R28 billion sought by the Treasury in the current fiscal year with the added advantage of targeting consumption rather than savings. It is argued that VAT should not be increased because it is a regressive tax. Nonetheless, this can be addressed through zero-rating and exclusions related to products that form the largest component of the shopping basket of the poor. Indeed, the National Treasury notes in its 2017 Budget Review that VAT is actually marginally progressive. It also observes in its 2016 Budget Review that South Africa's VAT rate is low compared with other countries and that it's personal and company income tax rates are both high by comparison.

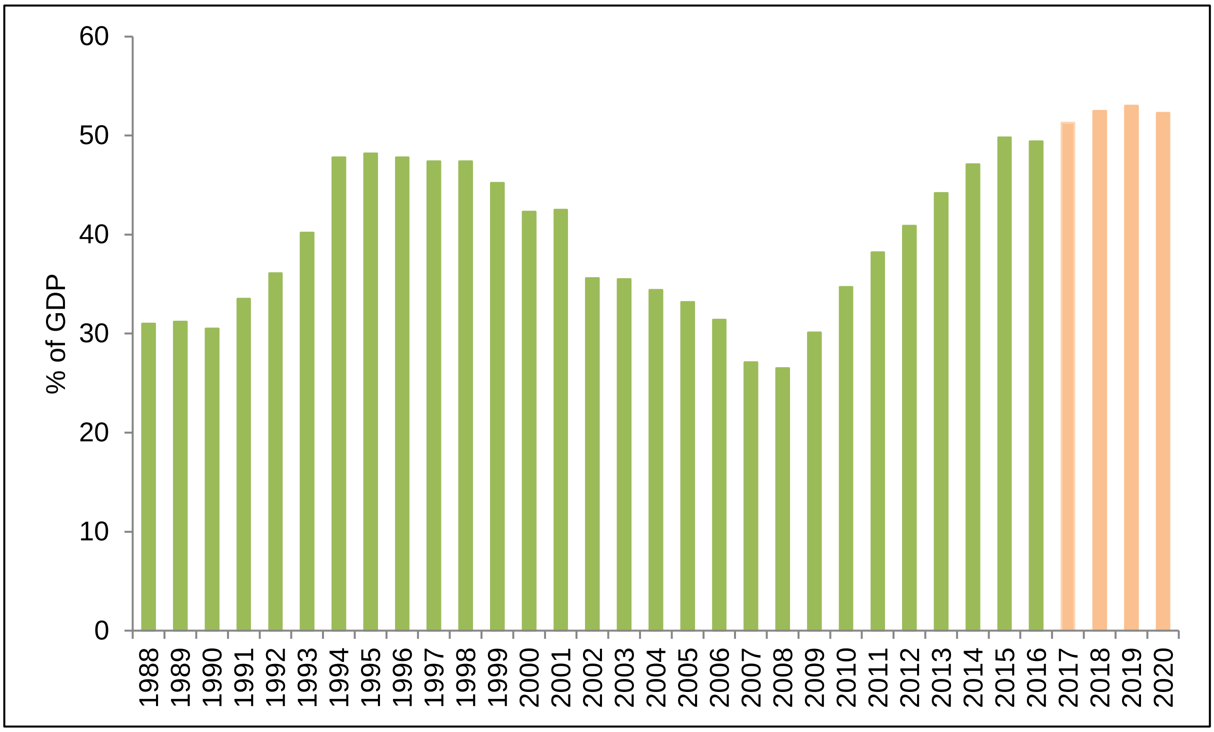
Looking ahead, the question is whether the tax burden is likely to increase further. Current information suggests the answer is yes. Consolidated government revenue is expected to increase from 29.4% of GDP in 2016/17 to 29.8% of GDP in 2017/18 and further to 30.1% of GDP by 2019/20. Specifically, the Treasury has indicated it is likely to implement additional revenue raising measures totalling R15 billion in tax year 2018/19.

At least, the mooted introduction of the sugar tax, expected proceeds from the voluntary disclosure programme for non-compliant taxpayers with undisclosed off-shore assets and measures to counter base erosion and transfer pricing tactics by companies could net significant amounts of revenue, which are not yet included in the Treasury's revenue projections.

[1] Corporate income tax is paid before the distribution of dividends

But, that said, in order to stabilise the gross loan debt ratio at around 53% of GDP in 2018/19, as the Treasury aims to do, the economy must deliver a sustained economic upswing with no room for net new spending on, say, much needed health sector improvements. Indeed, real Main Budget non-interest spending per capita has remained unchanged in recent years as the Treasury stuck diligently to its expenditure ceiling. Meanwhile, although the Minister announced spending cuts of R26 billion over the next two years, this amount is over and above the R25 billion expenditure cuts announced for 2017/18 and 2018/19 when the Budget was read in February 2016. Hence, cumulative expenditure cutting measures over the period amount to R51 billion.

SA government gross loan debt actual and projected



Source: SA Reserve Bank, SA National Treasury

All of this leaves South Africa in an unenviable position. Judging from experience elsewhere, an ideal fiscal consolidation programme involves reducing government consumption in favour of capital expenditure, protecting the public sector's balance sheet and aligning tax policy to support saving and real economic activity.

However, an unemployment rate of 26.5% makes it difficult to cut spending further. Further, considering the increased emphasis on taxing income and savings and the weakening trend in the public sector balance sheet, it is apparent that South Africa is not on an optimal fiscal consolidation path, which implies long-term risk lingers, including to taxpayers.

Potential changes are not limited to tax rates. In its 2016 Medium Term Budget Policy Statement and in its 2017 Budget Review, for example, the National Treasury indicated it is conducting a review of factors which "narrow the corporate tax base, including tax incentives and deductions for excessive debt financing". It argues tax incentives, including direct transfers and tax and tariff rebates must be reviewed to determine their impact on real economic activity and employment creation. Where the costs outweigh the benefits the incentive may be repealed.

At least, the Treasury indicates in its 2017 Budget Review the learnership tax incentive is helping to underpin skills enhancement. It has been extended to 2022, while also being adjusted to boost support for development of scarce skills. Moreover, the Treasury indicates the employment tax incentive has promoted a “modest positive” impact on youth employment with no “notable” negative effects. Accordingly, it has been extended to 2019 in order for further evaluation to be completed.

Unfortunately, though, on balance, these developments, amongst others, in aggregate suggest uncertainty could linger as regards long-term tax liabilities, which may reduce the incentive to invest.

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