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

Representations on the Draft Rates and Monetary Amounts and Amendment of Revenue Laws Amendment Bill, 2018

We present herewith our written submissions on the above-mentioned Draft Bill.

Our submissions include a combination of representations, ranging from serious concerns about the impact or effect of certain provisions to simple clarification-suggestions for potentially ambiguous provisions. We have deliberately tried to keep the discussion of our submissions as concise as possible, which does mean that you might require further clarification. In this regard, you are more than welcome to contact us.

As always, PwC is thankful for being given the on-going opportunity to participate in the development of the South African tax law.

Yours sincerely

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Attached:
- Detailed submissions re proposed increase in rate of VAT from 14 per cent to 15 per cent (5 pages)
- Detailed submissions re 2018 Draft Rates and Monetary Amounts and Amendment of Revenue Laws Bill & Amendments to Regulations pertaining to "Electronic Services" (25 pages)

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PROPOSED INCREASE IN RATE OF VAT FROM 14 PER CENT TO 15 PER CENT

It seems to have been accepted by the National Treasury that the only way in which the required revenues can sustainably be raised is through an increase in the VAT rate. We are supportive of this view on the assumption that the proposed additional tax revenues are the only way in which to achieve the required fiscal consolidation.

There are, however, a number of issues associated with the increase in the VAT rate that need to be considered. We discuss these issues below.

Regressivity of VAT

It is acknowledged that the VAT increase does (even if technically it is largely neutral or mildly progressive due to the existing zero-ratings) have a greater effect on poor and low-income households who are more vulnerable to an increase in the price of goods and services than wealthier households. However, as pointed out by the DTC[1], the extent of this regressivity might be overstated when one considers that accumulated savings of the rich are used to fund consumption expenditure during retirement (i.e. "the lifetime income hypothesis"). That said, one cannot ignore the fact that poor households spend a greater proportion of their income than do wealthy households and therefore feel the effects of an increase in VAT to a greater extent.

Expansion of list of zero-rated goods

There has been much debate regarding how the impact of the increase in the VAT rate on poorer and lower-income households may be ameliorated. One of the ways in which it has been suggested this may be achieved is through the expansion of the list of goods that form part of the basket of zero-rated goods to include not only more basic food items, but other items that are regarded as necessities or basic, essential goods that are used by the poor (such as, for example, soap, textbooks, stationery, school uniforms, sanitary towels and medicines).

Problems

There are a number of problems with the adoption of this approach.

(1) Cost

An expansion of the list of zero-rated goods will, in all likelihood, be expensive in terms of the resulting amount of VAT foregone, thereby defeating the purpose of the increase in the rate (i.e. to raise additional revenue). A significant expansion of the basket may require a higher increase in the VAT rate in order to achieve the desired additional tax revenues, potentially creating a vicious circle. A full assessment and quantification of the cost involved will need to be conducted.

(2) Targeting

[1] At 21 of the DTC: First Interim Report on VAT.

An expansion of the list of zero-rated goods may inadvertently benefit wealthier households more than poorer households. For example, should the list be expanded to include school uniforms, wealthier households (that have children who attend private schools) would benefit to a far greater extent than poorer households (that have children that attend township schools where uniforms are invariably cheaper). The same would apply to many of the goods that have been suggested should be included in the basket of zero-rated goods. Consider, for example, soap. It is understandable that basic soaps are what is intended to be covered, but it would be all but impossible to draw a distinction between basic soaps and many luxury soaps used exclusively by wealthier households.

(3) Definitional issues

Associated with the issues relating to the targeting of the zero-rating of particular goods, there are practical issues associated with defining what should and should not fall within the definition of the relevant goods.

Elaborating on the "school uniform" example above, questions that could arise in defining what constitutes a "school uniform" could relate to what a school uniform actually is (i.e. is it simply what learners wear to school? What items of clothing are covered (e.g. should it cover blazers)? Does it include clothing used for school sports?).

(4) Abuse

Any expansion of the list of zero-rated goods has the potential for abuse. Once again, further elaborating on the "school uniform" example, a school uniform has more than one use: it may be used for its identified purpose (i.e. as clothing for school), but could also be used for other purposes (e.g. as clothing for casual wear by persons who might not even be learners), bearing in mind that the standard uniform of a white shirt and grey flannels or a skirt is entirely generic.

Again, a full impact assessment will need to be conducted in order to identify any possible abuse that might arise as a result of the inclusion of any particular good on the list of zero-rated goods; and measures will need to be implemented in order to minimize the potential for such abuse.

(5) General

The discussion under headings (1) to (4) above serves to illustrate the complexities involved in the expansion of the list of zero rated goods. While we have used the impact of the inclusion of school uniforms as zero-rated goods as an example, the problems and complexities extend to many other goods.

In summary, it is essential that the inclusion of any particular good on the list of zero-rated goods be considered carefully in order to fully assess the impact of such inclusion and to include measures that would minimize any negative impact of such inclusion. This is likely to be an exercise that requires considerable time and resources.

Views of the Davis Tax Committee on zero rating[2]

While it has been acknowledged by the Davis Tax Committee ("the DTC") that the zero rating of certain basic foodstuffs does, to some extent, address the inherent regressivity of the VAT, The DTC's strong recommendation was that no further zero rating should be considered. This is on the basis that, in the view of the DTC:

- In absolute terms, zero rating is of significantly greater benefit to more affluent households (and is therefore not optimal from an economic efficiency perspective).
- Zero rating is an extremely blunt and "second-best" instrument for addressing equity considerations.

In order to address the inherent regressivity of VAT, the DTC was of the view that it would be preferable to collect the relevant tax revenue and to redistribute the additional income through targeted transfers to the poor. We agree with this approach, although it would require the development and introduction of new instruments to reach the intended beneficiaries.

National Treasury study in 2006[3]

In a 2006 study by National Treasury relating to the taxation of basic foodstuffs and other so-called merit goods, it was found that the zero-rating of specific foodstuffs provides a larger proportional benefit to the poor (i.e. enhancing the progressivity of the system), but provides a larger absolute benefit to the rich (who consume larger quantities of the relevant goods). The study in fact argued that the poor would be better served by the elimination of zero ratings and by applying the additional revenue realized to pro-poor spending in the budget (i.e. the targeted transfers to the poor as referred to by the DTC).

Alternatives to expansion of list of zero rated goods

In our view, such targeted transfers to the poor could take the form of, for example, the distribution of food vouchers/stamps to poorer households or increased social grants.

Regarding the distribution of food stamps/vouchers to the poor, this approach would have the added benefit of assisting poor households that do not currently benefit from, for example, social grants or lower marginal income tax rates (because they are unemployed or earn below the income tax threshold). A further benefit would be that it ensures that the benefit is used for food (and not, for example, undesirable expenditure such as alcohol, entertainment and gambling). An example of such a system is to be found in the United States Supplemental Nutrition Assistance Program which provides nutritional assistance to low-income households in amounts depending on the household's size, income and expenses through a a specialised debit card system which is used to pay for food at supermarkets, convenience stores, and other food retailers.

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[2] Davis Tax Committee: First Interim Report on VAT, July 2015; Paragraph 7.2, pp 20 – 27.
[3] The VAT Treatment of Merit Goods and Services, National Treasury T16/05

Perhaps the greatest benefit of the introduction of such an instrument would be that, unlike the use of zero ratings (which, as pointed out by the DTC, in fact benefit the wealthy more than the poor in absolute terms), such an instrument would exclusively benefit the poor, both in absolute and relative terms and would therefore be economically efficient.

It is, however, acknowledged that the introduction of such a new instrument (i.e. food stamps/vouchers), is not a short-term solution and will require time and resources to develop and implement.

Review of current list of zero rated food items

Irrespective of whether or not the list is expanded to include additional items, we are supportive of calls that have been made for a review of the current list in order to assess whether or not it is appropriate and whether certain items (that are perhaps less appropriate for inclusion) should be removed in order to provide space for other more appropriate items to possibly be included.

Such a review should be conducted with due consideration to the concerns raised above relating to the expansion of the list of zero-rated goods. In the context of food items, of particular concern is the targeting of the relevant zero-rating, as well as the definitional issues involved, in order to ensure that it is the poor and lower-income earners who benefit more from the zero-rating. Thus, for example, consideration would need to be given to what categories or types within the same item should be zero rated (e.g. as posed by the Standing Committee on Finance, while apples, bananas and oranges might be zero-rated, should kiwi-fruit, grapefruit or mangoes be zero rated? While onions, potatoes and tomatoes are zero-rated, should Brussel sprouts and turnips be zero rated?). We agree with these questions, but suggest that the question goes even further. For example, if tomatoes and potatoes are to be zero-rated, which types of tomatoes and potatoes should be zero-rated and which not? Should cherry tomatoes be zero-rated and should the zero-rating of potatoes extend to washed and peeled potatoes? Should the zero-rating of apples, bananas and oranges extend to a prepared fruit salad of apples, bananas and oranges? The above is illustrative of both the inherent inefficiency in the current basket of goods and the depth and complexity of any review of the basket should take.

The efficacy of zero rating

As has been acknowledged by commentators, the benefit that arises from the zero rating of a particular good is invariably not completely passed on to the intended beneficiary (i.e. the consumer). This is based on the operation of the simple economic laws of supply and demand, which inevitably result in the supplier sharing in at least some of the benefit.

The introduction of a higher VAT rate on “luxury goods”

It is argued that further consideration should be given to the introduction of a “multi-rated” VAT system in which VAT on luxury goods is higher than VAT on goods purchased by the poor and lower-income earners.

We would not support the adoption of such an approach. As pointed out by the DTC[4], "it cannot be emphasized too strongly that the official administrative costs and traders' compliance costs rise dramatically as the number of rates multiply and nothing much is gained in terms of revenue"[5]. Generally, the DTC was of the view that multiple rates are inefficient, both economically and administratively, and that the added benefit therefrom is minimal as a result. In addition, such an approach gives rise to market distortions as certain goods and services throughout the production/distribution chain are given preference over others.

In our view, an additional problem would be that the introduction of a differential rate could potentially also result in the frustration of other governmental policy objectives (for example, if "smartphones" are regarded as "luxury items" and subject to VAT at a higher rate, this could affect telecommunications policy objectives aimed at ensuring broader access to the internet).

As alluded to by the DTC, a preferable approach would be an increased application of *ad valorem* duties on luxury goods. The benefit of *ad valorem* duties over VAT is that the tax is collected at the stage of production or import, and the number of traders that will need to administer the system is limited (compared to a VAT differentiation that needs to be complied with by all traders in the production/distribution chain)[6]. If it is considered that progressivity of the tax system should be increased through the taxation of certain luxury goods at a higher rate than other goods, this should be done through the expansion of the list of goods subject to *ad valorem* duties rather than the introduction of a luxury rate of VAT.

[4] At page 27 of the DTC: First Interim Report on VAT
[5] Tait, A.A. Value-Added Tax: International Practice and Problems, 1988, Washington D.C., International Monetary Fund.
[6] At 29 of the DTC: First Interim Report on VAT.