Province of KwaZulu-Natal
Provincial Treasury
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Implications of an increase in Value Added Tax (VAT)

1. Introduction

Taxation is one of the essential fiscal instruments that governments use to influence the economy of a country. It is a critical element of the fiscal policy that, in most instances, determines the extent to which the government can fund public services. The amount of tax levied is inherently charged either directly on earnings (direct tax) or indirectly on consumption of certain products (indirect tax).

Direct taxes refer to the tax levied on earnings such as employees' salaries and companies' profits. The examples of such taxes include the personal income tax (PIT) and corporate tax, among others. Whereas, indirect taxes refer to the tax charged on transactions or sales of certain products. The most common examples of indirect taxes are Value Added Tax (VAT) and the customs duties.[1]

The South African government fiscal authority (National Treasury) increased VAT rate by one percentage point earlier in April this year. This hike in VAT rate has since received a wide range of attention from a number of stakeholders. The main criticism relates to the argument that a VAT increase will affect the standard of living for the poor and low-income households. In this respect, it is important to analyse the effects a VAT increase on households, particularly poor and low-income households, as well as the effects on government revenue.

The primary aim of this newsletter is therefore to discuss the effects of a VAT increase in South Africa (SA). The analysis begins by providing a brief discussion of a South African VAT system. This is followed by a comparison of tax instruments for different countries, fiscal policy in SA, and the rationale for a VAT increase. The article further discusses the disadvantages of a VAT increase and conclude by outlining the government interventions to provide a tax relief to the consumers, especially the poor and low-income households.

2. South African Value-Added T*ax system*

In SA, VAT was introduced in the early 1990s to replace the General Sales Tax (GST)[2]. According to Erero (2015)[3], VAT is a broad-based tax on consumption rather than a selective tax on particular products, primarily because it is intended to tax all consumption of goods and services in an economy.

Given that VAT is charged at each stage of the production and distribution chain, it, therefore, becomes a reality that it is generally borne by the end consumer. However, some goods and services are regarded as zero-rated[4], implying that no tax is levied on their supply. The zero-rated goods and services include the basic food items as well as petrol, diesel and illuminating paraffin, among others. The purpose of zero-rating was to provide tax relief to consumers, particularly the poor and low-income households.

Initially, VAT was charged at 10% in 1991, before increasing to 14% in 1993. It was, however, increased further to 15% in April 2018. SARS (2013)[5] indicated that VAT is among the largest tax instruments such as personal income tax, and company income tax which comprise approximately 80% of the country's total tax revenue.

3. Tax instruments in other countries

Table 1 reflects the major tax instruments for different countries in 2018. It is evident from that table that the current SA's VAT rate of 15% is still below that of its trading partners, particularly the BRICS[6] countries and other Emerging Market Economies (EMEs).

Table 1: A comparison of Tax rates in SA and other countries in 2018

Countries	Personal income tax	Value Added Tax	Corporate tax
	2018		
Brazil	22.5	17.0	34.0
China	45.0	17.0	24.0
India	35.5	18.0	35.0
Russia	13.0	18.0	20.0
South Africa	45.0	15.0	28.0
Mexico	35.0	16.0	30.0
Chile	35.0	19.0	26.0
Malaysia	28.0	6.0	24.0
Plilippines	35.0	12.0	30.0
Turkey	35.0	18.0	22.0
Angola	17.0	10.0	30.0
Kenya	30.0	16.0	30.0
Nigeria	24.0	5.0	30.0
Egypt	22.5	14.0	23.0

Source: Trading Economics, 2018

VAT for the BRICS countries such as Brazil and China is 17 % whilst that of India and Russia is 18 %. The EMEs that have high VAT rate

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1 Other examples of indirect taxes are sales tax, excise duties and export duties.

2. Similar to the VAT, GST is a consumption tax charged on consumers. It refers to a taxing system as a whole where people are taxed based on how much they consume as opposed to income tax that is based on how much people earn. In SA retail price was exclusive of GST but added at the time of selling (seen: http://lumensoft.biz/images/stories/downloads/GST.pdf, accessed on 07/08/2018).

3 Erero, J. (2015): *Effects of Increases in Value Added Tax – a Dynamic CGE Approach,* ERSA working paper 558, November 2015, available online: https://econrsa.org/system/files/publications/working_papers/working_paper_558.pdf, accessed on 02/08/2018.

4 Inchauste *et al*., (2015): *The Distributional Impact of Fiscal Policy in South Africa*. There are 19 food items that qualify for zero-rating, this includes the following: brown bread, maize meal, samp, maize rice, dried maize, dried beans, lentils, tinned pilchards/sardines, milk powder, dairy powder blend, rice, vegetables, fruit, vegetable oil, milk, cultured milk, brown wheaten meal, eggs and legumes/pulses.

5 SARS (2013): *Tax Statistics 2013, a* joint publication between the National Treasury and the SARS, available online: http://www.treasury.gov.za/publications/tax%20statistics/2013/TStats%202013%20WEB.pdf, accessed on 01/08/2018

6 BRICS countries are Brazil, Russia, India, China and SA.

compared to that of SA is Chile at 19% and Turkey at 18%. However, the domestic VAT rate is somewhat higher than that of the Sub-Saharan African (SSA) economies such as Egypt (14%) and Angola (10%), the only exception is Kenya with 16% (Table 1).

With regards to other tax instruments, the table shows that SA and China have the largest personal income tax rates at 45%. This tax rate is higher than that of other trading partners such as BRICS countries and SSA economies. The country's corporate tax rate of 28% is higher than China (24%) and Russia (20%). The SA's corporate tax is, however, lower than that of Brazil (34%) and India (35%).

4. Fiscal policy in South Africa

The South African fiscal policy has, over the past decade, been characterised by a huge budget deficit and accelerating government debt-to-GDP ratio. These challenges emanated partly from the negative effects of the global financial crisis of 2009. For instance, the government debt-to-GDP began to rise from the all-time low of 28% in 2008 to 40.8% in 2014, 45.5% in 2016 and is currently[7] at 55.1% (Also see Table 3). This unprecedented rise was due to the countercyclical fiscal stimulus enforced to reduce the effects of the global recession[8].

Consolidated fiscal framework

Table 2 portrays the consolidated fiscal framework from the 2014/15 to the 2020/21 fiscal period. The total expenditure has been greater than the total revenue over time, thereby resulting in a budget deficit of R139.7 billion in 2014/15 and R204 billion in 2017/18. The budget deficit widened substantially in the 2017/18 fiscal year when compared to the previous periods. The huge revenue gap is attributable to among other things, low revenue collection and high expenditure. It is worth noting that the non-interest expenditures comprise a great proportion of the total expenditure. Encouragingly, the fiscal deficit is projected to slow down to approximately R180.5 billion in the 2018/19, before moderating to R193.3 billion in 2019/20 (Table 2).

Table 2: Consolidated fiscal framework, 2014/12 to 2020/21

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Rbillion/percentage of GDP	Outcome			Revised estimate	Medium-term estimates		
Revenue	**1 095.3**	**1 215.3**	**1 285.7**	**1 353.6**	**1 490.7**	**1 609.7**	**1 736.9**
	28.3%	29.5%	29.2%	28.8%	29.7%	29.9%	29.9%
Expenditure	**1 235.0**	**1 366.2**	**1 441.8**	**1 558.0**	**1 671.2**	**1 803.0**	**1 941.9**
	31.9%	33.1%	32.7%	33.2%	33.3%	33.4%	33.4%
Non-interest expenditure	1 113.60	1 227.80	1 285.00	1 387.00	1 483.40	1 596.90	1 718.00
	28.8%	29.8%	29.2%	29.5%	29.5%	29.6%	29.6%
Budget balance	**-139.7**	**-151.0**	**-156.1**	**-204.3**	**-180.5**	**-193.3**	**-205.0**
	-3.6%	-3.7%	-3.5%	-4.3%	-3.6%	-3.6%	-3.5%

Source: National Treasury, 2018 [9]

Government debt and debt-service costs

Table 3 displays the government debt and debt-service costs from the 2014/15 to the 2020/21 fiscal year. The table shows that the government gross loan debt has been increasing over this period. It rose from R1.584 trillion in the 2014/15 fiscal year to R2.006 trillion and R2.506 trillion in the 2016/17 and 2017/18 fiscal years, respectively.

Table 3: Projected state debt and debt-service costs, 2014/15 to 2020/21

Rbillion/percentage of GDP	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
	Outcome			Revised estimate	Medium-term estimates		
Gross loan debt	**1 584.0**	**1 804.4**	**2 006.1**	**2 506.1**	**2 770.6**	**2 983.3**	**3 250.0**
	40.8%	44.3%	45.5%	53.3%	55.1%	55.3%	56.0%
Debt-service costs	**115.0**	**129.1**	**146.3**	**163.2**	**180.1**	**197.7**	**213.9**
	3.0%	3.2%	3.3%	3.5%	3.6%	3.7%	3.7%

Source: National Treasury, 2018

The public debt level is expected to reach R2.771 trillion in the 2018/19 financial period, and increase further to R3.250 trillion in the outer year of the 2018/19 Medium Term Expenditure Framework (MTEF). The rising debt level is largely driven by the budget shortfalls that have been recorded over the same period (Table 2). Ultimately, government uses borrowed funds to bridge the revenue gaps and thus maintain the spending pattern on socio-economic imperatives.

Disturbingly, the debt level has been increasing alongside the debt-service costs, thereby putting pressure on the national budget. The National Treasury (2017)[10] indicated that the debt-service costs are among the fastest growing elements of the national budget.

Table 3 shows that the debt-service costs rose from R115 million in the 2014/15 financial year to R163.2 million in the 2017/18 financial period. It is expected to increase further to R180.1 million and R231.9 million over 2018/19 and 2019/20 financial years. Thus, the debt-service costs contribute substantially to the high non-interest expenditure (Table 3).

5. Rationale for a VAT increase

The preceding section outlined the fiscal policy of the country, which has been recording budget deficit over time. Given the substantial increase in the budget deficit in the 2017/18, the government resolved to increase taxes in order to reduce the revenue gap and stabilise the debt level.

It must be noted that there are numerous other sources that would have been used to finance the revenue gap such as borrowing, or increasing other tax instruments rather than VAT. However, VAT increase was a necessary decision given the current fiscal policy stance and economic climate.

[7] National Treasury (2018): *Budget Review*, 2018, available online http://www.treasury.gov.za/documents/national%20budget/2018/review/FullBR.pdf, accessed on 21/0/06/2018.

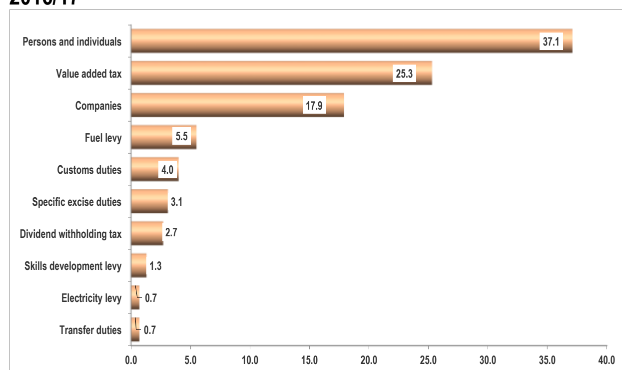
[8] Schoeman, M. (2015). Public debt and Post-crisis fiscal policy in South Africa, available online: http://wiredspace.wits.ac.za/handle/10539/19173, accessed on 15/06/2018.

[9] National Treasury (2018): Budget Review. Available online: http://www.treasury.gov.za/documents/national%20budget/2018/review/FullBR.pdf, accessed on10/06/2018.

[10] See the National Treasury (2017): MTBPS, available online: www.treasury.gov.za.

The VAT hike was necessary in a sense that, there was no other tax instrument that had a potential to raise the large pool of funds needed by the government over the MTEF. This sentiment was also echoed by the former Minister of Finance, Mr Melusi Gigaba, in his budget speech in February 2018, who maintained that raising VAT was unavoidable to maintain the integrity of public finances.

Figure 1: Contribution to gross tax revenue by tax instrument, 2016/17



Source: National Treasury, 2018

The National Treasury (2018)[11] indicated that a percentage point increase in VAT will generate a revenue of approximately R23 billion. Figure 1 shows the contribution to gross tax revenue by tax instrument during the 2016/17 fiscal period. The figure indicates that VAT was the second largest contributor to tax revenue at 25.3%, following the personal income tax which stood at 37.1% over the same period.

Moreover, it is reasonable to argue that VAT is a significant source of tax revenue in the country. This is attributable to its nature, in a sense that it cannot be easily evaded or avoided.

Other financial sources

Government borrowing is among the financial sources that can be used to reduce the budget deficit. However, as demonstrated in table 3, the national government gross loan debt is already high and puts pressure on the national budget through servicing costs.

Government is also under severe pressure to stabilise the debt levels in order to halt the negative consequences associated with a large debt stock, particularly as recommended by the sovereign credit rating agencies such as Moody's, Standard & Poor and others. In some instances, further borrowing could lead to a debt-overhang[12]. Therefore, borrowing was not an ideal option for the government to finance the revenue gap.

The second option could be hiking other tax instruments such as the personal income or company tax. In SA, the personal income tax has been increasing over the years. Further to this, the tax specialist, Judge Dennis Davis[13], indicated that an increase in personal income tax would not have yielded the required amount to reduce the revenue gap.

The company tax, on the other hand, was not increased given the falling company tax in advanced and middle-income countries, which affects SA's global competitiveness. Judge Davis also indicated that an increase in the company tax would have tarnished the SA's competitiveness within the African continent. He further argued that in order to get the R23 billion raised through the VAT increase would have required a significant increase in the corporate tax rate. This would have contributed to a greater retardation of the growth rate than the VAT increase.

6. Disadvantages of a VAT increase

Households

The recent tax hike has created an on-going debate among leaders as it includes VAT. The main criticism of increasing VAT is that it will negatively affect the consumers particularly the poor and low-income households. This argument is also underpinned by the economic theory which suggests that VAT is regressive, implying that it affects consumers negatively.

VAT affects the consumers by increasing the costs of living primarily, the basic foodstuff, clothing and other important products (Kearney & van Heerden, 2003)[14]. In this regard, it is believed that VAT increase will lower the standard of living for the poor and low-income households through higher costs of living.

Generally, VAT hike implies that consumption for most products will increase except those that are tax exempt. Therefore, it will lead to a higher cost of living for the consumers. Although VAT affects all consumers irrespective of their income category, however, the effect is literally more pronounced on the poor and low-income households compared to other income groups.

The former bear pronounced effects due primarily to their low income that cannot cover all the essential goods and services. There is a variety of transactions that get affected by a change in VAT such as the

[11] National Treasury (2018): *Budget Review*, 2018, available online: http://www.treasury.gov. za/documents/national%20budget/2018/review/FullBR.pdf, accessed on 21/0/6/2018.

[12] Debt overhand refers to the presence of a large debt level that has adverse effects on investment and growth. This is because investors expect that current and future taxes to be increased to effect the transfer abroad. (See IMF,1996: *External Finance for Low-Income Countries*, Papers presented at the IMF and World Bank Conference on the External Financing for Low-income countries, 10 – 11 December 1996, edited by Z Iqbal and R Kanbur, available online: ttps://books.google.co.za/books? Accessed on 12/07/2018).

[13] Judge Dennis, Judge of the High Court is a member of the Commission of Enquiry into Tax Structure of SA.

[14] Kearney, M. and van Heerden, J.H. 2003: *A Static, Stylized, CGE model applied to evaluate the incidence of Value Added Tax in South Africa*, available online: web.up.ac.za/UserFiles, accessed 15/6/2018.

purchasing of clothes, cosmetics, water, electricity and other food items, among others. According to the PACSA's (2018)[15] food basket, the percentage point VAT hike resulted in a 6.5% increase in the total VAT component. The VAT component increased from R208.10 in March 2018 (14% VAT) to R221.59 in April 2018 (15% VAT)[16]. This indicates a significant change in the cost of the food basket. In this regard, the poor and low-income households will need to change their food baskets in order to cater for the increase in VAT.

Another course for concern is the reality that, though there are zero-rated items, the challenge, however, is that with the exception of unprocessed goods, the zero rating applies at the final product level rather than at primary input level. Brown bread, for example, is zero-rated, but its primary inputs such as flour, water and electricity remain at standard-rated.

Business sector

The common consequence of VAT increase has knock-on effects on the production value chain. However, the rate hike should not necessarily have a major impact on business-to-business transactions, due to the regressive effects of the VAT.

The main implication that the increase in VAT to 15% will have on entrepreneurs is that they will have to increase their product or service price. The VAT increase could also result in raised business costs, which would then be passed onto the end consumers.

Government

Table 4 provides a sample of the vatable items for the KZN Department of Education (DoE) at 14% and 15% VAT rates. The total expenditure inclusive of VAT charged at 15% increases by approximately R42.9 million, up from the budgeted R690.855 million to R733.765 million. This indicates a negative effect of a VAT hike on KZN DoE expenditure, a trend that is evident across departments in KZN.

Table 4: Vatable items for KZN Department of Education 2018/19

VATABLE ITEMS	BUDGET 2018/19	14% VAT	15% VAT	VAT INCREASE IMPACT
	R'000	R'000	R'000	R'000
Contractors	R800	R98	R104	R6
Learner Teacher Support Material	R611 799	R75 133	R79 800	R4 667
Materials and supplies	R9 044	R1 111	R1 180	R69
Other supplies	R212 295	R26 071	R27 691	R1 619
Consumable supplies	R114 197	R14 024	R14 895	R871
Stationery, printing & office supplies	R39 565	R4 859	R5 161	R302
Operating leases	R91 329	R11 216	R11 912	R697
Property payments	R484 142	R59 456	R63 149	R3 693
Machinery and equipment	R20 076	R2 465	R2 619	R153
Software and other intangible assets	R4 000	R491	R522	R31
Total	**R5 625 534**	**R690 855**	**R733 765**	**R42 910**

Source: KZN Treasury, 2018[17]

The essential services for the department such as the Learner teacher support material (LTSM), stationery, printing & office supplies, and contractors will be affected. Moreover, there is no funding provided for the additional percentage point resulting from the increase in VAT. The departments are therefore pressed further to reprioritise their budgets in order to provide the services that were budgeted for in the 2018/19 financial year.

7. Government interventions

Even though the tax increase was necessary to achieve fiscal commitments, however, it has had a negative impact on the consumers. Consequently, government is committed to put in place some intervention(s) seeking to provide tax relief to consumers. Firstly, government increased social grants, particularly the child support and old-age pension grants. This was because mainly grant beneficiaries are unemployed and thus depend largely on government transfers.

Secondly, National Treasury (2018)[18] has released a report conducted by an independent panel of experts, headed Prof Ingrid Woolard[19]. The panel was mandated to review the current list of zero-rated food items and to consider additional items that can be included to mitigate the impact of the VAT increase on poor and low-income households[20]. The report recommends that white bread, cake flower, bread flour, sanitary products, school uniforms and nappies be included amongst items that are zero-rated for VAT.

In total, the committee considered the exclusion of eight items with a combined cost to the fiscus of R10.4 billion.[21] Given the lack of consensus among the panel members in respect of poultry and baby formula (milk), these items were eventually not recommended due to public health considerations. For school uniforms, the suggestion is that

[15] Pietermaritzburg agency for community social action (PACSA) is a faith-based social justice and development NGO that has been in operation since 1979. See https://www.pacsa.org.za/images/food_barometer/April_2018_PACSA_monthly_food_price_barometer.pdf, accessed on 29/06/2018.

[16] Pietermaritzburg agency for community social action (PACSA): Monthly Food Price Barometer: APRIL 2018. Available online: https://www.pacsa.org.za/images/food_barometer/April_2018_PACSA_monthly_food_price_barometer.pdf, accessed on 07/08/2018.

[17] The table shows selected government expenditures, a full list of expenditures is available on request.

[18] Treasury (2018): *Recommendations on Zero Ratings in the Value-Added Tax* System, report was released on 10 August 2018 and is available online: http://www.treasury.gov.za/comm_media/press/2018/2018081001%20VAT%20Panel%20Final%20Report.pdf, accessed on 13/08/2018.

[19] Ingrid Woolard is Professor in the School of Economics at the University of Cape Town, a Research Associate of the Southern Africa Labour and Development Research Unit (SALDRU) and a Research Fellow of the Institute for the Study of Labour (IZA). Her areas of research interest include labour markets, social protection, tax policy and the measurement of poverty and inequality (see Proof Woodard's VC, available online: https://www.news.uct.ac.za/downloads/email/CV.Abbrev.IWoolard.2015.pdf, accessed on 28/06/2018.

[20] See footnote 4 in section 2 of this publication.

[21] The total cost for each item are estimated as follows: white bread (R1.78 billion), bread flower (R0.15 billion), cake flower (R0.59 billion), sanitary products (0.11 billion), school uniforms (0.62 billion) and nappies (R0.75 billion), poultry (R5.98 billion and baby food/milk (R0.46 billion). Collectively, these eight items accounts for VAT revenue of R10.44 billion (National Treasury, 2018).

this should only be zero-rated if it can be distinguished from general clothing.

In addition, the report estimates that the proposed SA zero-rating VAT plan could cost government R4 billion. However, this newly recommended zero-rated VAT list would provide tax relief of about R2.8 billion for the poorest households.

Over and above the zero-rated items, the report further recommends that the government should consider intensifying the support programmes aimed at as assisting poor households. This includes strengthening the National School Nutrition Programme (NSNP) and increasing the provision of transfer payments especially in respect of the child support and old-age pension grants as mentioned above.

However, the recommendations will be evaluated by the National Treasury and the SA Revenue Service (SARS), whilst at the same time taking into account the public comments. The general public is expected to comment on the proposed recommendations before the end of August 2018.

8. Concluding remarks and recommendations

As demonstrated in this article, the government was compelled to increase VAT from 14% to 15% in April of this year to generate much-needed revenue to bridge the fiscal gap, and thus stabilise the government debt-to-GDP ratio. Despite this increase, in comparison to other countries, including BRICS, South African VAT has been relatively low at 14% over the past two decades.

As argued by the National Treasury, VAT was the most cost-effective method of raising revenue, especially as company tax in most advanced and emerging market & developing economies is declining which affect the country's international competitiveness. Hence, in order for the country to gain global competitiveness and also attract foreign investment, it needs to reduce company tax to the level of its peers.

Nonetheless, government has put measures in place to cushion the effects of an increase in VAT, particularly where the most vulnerable are concerned, for an example, increasing social grants. Further to this, the government has also commissioned a comprehensive study to review the current list of VAT zero-rated items and consider the most effective way to mitigate the impact of the increase in the VAT rate on poor and low-income households.

The final report of the study recommends that white bread, sanitary products, school uniforms and nappies be included amongst items that are zero-rated for VAT. Finally, in preparation for the 2019/20 budget, it is recommended that Departments in KZN quantify their total additional costs, resulting from the increase in VAT and provide mechanisms, which they have put in place applied to fund these extra costs.

Province of KwaZulu-Natal

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KwaZulu-Natal Provincial Treasury
Treasury House
145 Chief Albert Luthuli Road
P O Box 3613
Pietermaritzburg
3201