Structural tax reform needed to promote economic growth: PwC Tax Services

A reform of South Africa's tax system is high on the agenda. This comes in the wake of Finance Minister Nhlanhla Nene's recent Medium Term Budget Policy statement that changes are set to be made to tax policy in the 2015 Budget. The government is proposing a fiscal package that reduces the expenditure ceiling and raises tax revenues by at least R44 billion over the next three years.

The Medium Term Budget Policy Statement states that-
"Government proposes a structural increase in revenues over the medium term. Policy and administrative reforms will raise at least R12 billion in 2015/16, R15 billion in 2016/17 and R17 billion in 2017/18. The details of proposed changes will be announced by the Minister of Finance in February when he tables the 2015 Budget in Parliament.
The proposals will enhance the progressive character of the fiscal system, improve tax efficiency and realise a structural improvement in revenue. The short- and long-term implications for economic growth and job creation will be a key consideration."

PwC supports a policy of structural tax reform provided it is done in a manner that is supportive of economic growth. This means increasing those taxes that have the least negative impact on economic growth, investment and employment, while at the same time reducing reliance on taxes that distort incentives to work and invest.

Getting the structure of the tax system right can boost economic growth and lift employment.

Tax policy at its broadest level involves a determination of the overall level of taxation in the economy (essentially the extent of the role that government will play in the economy) and the amount of tax revenue to be derived from the various tax instruments (the tax mix). Another aspect that needs to be considered in the equation is the overall progressivity of the fiscal system. Ultimately, a number of different, and often competing, objectives need to be balanced against each other.

South Africa's tax-to-GDP ratio is budgeted to be 26.5% in 2014/15. This ratio has been on an increasing trend since 2003/4 when it was at 23.2%, but is still a little way off the peak of 27.6% of 2007/8 after which it fell dramatically to 24.4% in the wake of the global financial crisis.
However, taking into account World Bank Indicators, the South African tax-to-GDP ratio is higher than the world average of 14.5%, the African average of 14.4% and the average for developing countries in general. When most social security taxes are excluded, South Africa has the tenth highest tax-to-GDP ratio in the world.

Given the current scenario, there is little scope, if any, to increase taxes without negatively impacting economic growth. Ideally, South Africa should be looking to reduce its tax burden over the medium term in order to increase its attractiveness as an investment destination and promote economic growth. However, this is probably not feasible having regard to the current economic and fiscal climate.
Personal Income Tax was the largest source of revenue collected for 2013/14 totaling R310.9bn (34.5%). VAT was the second largest contributor to total tax revenue, totaling R237.7bn (26.4%). The third largest contributor to total tax revenue was corporate income tax totaling R179.5bn (19.8%).

Currently, South Africa has a high reliance on tax revenues from corporate taxes that does not compare favourably to global averages. In 2010 the average contribution of corporate tax to total tax revenues for OECD countries was 8.6%. The comparable figure for South Africa was 23% and has since

stabilised to around 20%.
The South African tax system does not support economic growth as well as it could. This is due to the mix and rates of different types of taxes, in particular the high reliance on corporate income tax and personal income tax.

Studies carried out by the OECD show that corporate income tax is the least growth friendly type of tax, followed by personal income tax and indirect taxes, respectively.
Progressively altering the mix of taxes to support economic growth, while simultaneously supporting fiscal sustainability, will produce clear benefits in the future. As part of its terms of reference, the Davis Committee is tasked with considering and making recommendations on the overall tax base, tax burden and tax mix. This, together with the statements made in the Medium Term Budget Policy Statement, presents an ideal opportunity for South Africa to structurally reform its tax mix to align with the objectives of the National Development Plan and make South Africa’s tax system more conducive to economic growth.

Any such reform would, by necessity, entail a shift in taxes away from corporate income tax and personal income tax to indirect taxes and Value-Added Tax in particular. A number of benefits would arise from such a shift. South Africa’s reliance on corporate income taxes and the volatile nature of corporate earnings would be reduced. As such, tax revenues would be more stable and a little less vulnerable to economic shocks. Lower taxes on income would promote greater levels of savings, investment and entrepreneurship and would therefore be more conducive to investment-led growth. Increasing taxes on consumption would act as a deterrent to high levels of consumption, further incentivising savings and reducing reliance on unsustainable consumption-led growth. A reduction in consumption would, in addition, have positive implications for South Africa’s high current account deficit.

The goal of tax reform should be to promote economic growth and to build a sustainable revenue base for government, without compromising the equity and fairness of the system. We believe that consideration should be given to a realignment of the tax mix between income taxes and consumption taxes. In this regard, a reduction in income taxes and an increase in consumption taxes should be considered. On the face of it, such reform would be a hard-sell from a political point of view because of the effects that such reform would have on the poor by increasing the amount of taxes they pay in the form of VAT. However, if tax reform is packaged together with social security reform to alleviate the increased burden on the poor, it may make such tax reform politically feasible. It is possible to alleviate the burden for the poor through the social security system and through the personal income tax system.