

Chapter 6

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

6.1. Summary

Poverty, inequality and unemployment are realities within the South African economy, and policy intervention is called for. One policy intervention strategy is restructuring VAT. Lowering the statutory VAT rate may possibly give poverty relief as the VAT burden is reduced. Zero-rating food, a commodity used relatively more intensively by poor households, may also possibly alleviate poverty and at the same time improve the regressiveness of VAT. This will result in a more equitable tax structure, as the overall progressiveness of the tax structure is improved. Restructuring VAT by zero-rating labor-intensive service industries may possibly alleviate unemployment. An attempt to answer the questions on how these changes in the VAT structure would impact on the economy is answered below.

VAT was introduced in South Africa in 1991 to replace GST. VAT is an indirect tax and is levied on the value added in production during the different stages of production. VAT in South Africa is a consumption-based tax, as the tax burden rests with the consumer. VAT in South Africa is levied at the place of destination. This means that exports are excluded from VAT, while imports are taxed. In South Africa VAT liability is computed, using the invoice method. The invoice method charges VAT on outputs, while credits are given on inputs. The person or business liable for VAT must provide invoices as proof of inputs. Other methods available are the subtraction and cash flow methods. Furthermore, in South Africa various products and firms are excluded from VAT. Certain food items consumed mostly by poor households are excluded: maize, brown bread, samp, paraffin, etc. Small firms are also excluded from VAT; firms realizing a turnover of less than R300 000 per year are not required to register as a VAT payer. Certain services provided within the financial sector are also excluded, as it is difficult to determine a transaction value for these services. However, the financial

service sector is not excluded in full. South Africa uses a single-rate VAT system (14 percent from 1993) unless items are zero-rated or excluded.

Evaluating VAT over the period 1991 to 2001 showed that VAT is an important revenue source for government; it is the second largest revenue source next to income taxes and contributes up to 25 percent of total tax receipts. The government sees VAT as a broad-based revenue source, since 1994 the C-efficiency ratio was above 100 percent, showing that the VAT base is relatively broad, and is steadily increasing. However, VAT is still mildly regressive, even taking the initial zero-rating into account. Poor households spend up to 3.5 percent of their income on VAT, compared to high-income households who only spend 2.5 percent of their income on VAT.

Restructuring VAT may possibly achieve the strategies set by GEAR, namely growth employment, and redistribution. The issues to consider with their expected effect are listed below:

- The government lowered the direct tax rate for the last two budget years (2003 and 2002) as an expansionary measure. The alternative of lowering the statutory VAT rate needs to be investigated. The question whether or not a reduction in the VAT rate may achieve the strategies set by GEAR needs to be answered.
- Poor households face severe poverty. Zero-rating food, a commodity used most intensively by poor households, may possibly give immediate poverty relief. Furthermore VAT is still mildly regressive, and zero-rating food may possibly reduce the regressiveness of VAT. The loss in revenue, due to the zero-rating of food, needs to be absorbed by alternative sources. The effect of zero-rating food and the use of alternative sources on welfare and tax efficiency, need to be investigated.
- The possibility of applying zero-rating to labor-intensive industries with the aim to create jobs needs to be investigated as well. The financial service industry uses semi-skilled labor intensively, and zero-rating this industry may possibly generate employment. Again the loss in revenue needs to be absorbed by

alternative sources. The effect of zero-rating labor-intensive industries and the use of alternative sources on employment, welfare and tax efficiency, need to be investigated.

A CGE model is used to analyze the effect of changes in VAT on the economy. CGE models are highly suited to show the impact of VAT changes on distribution and welfare. CGE models incorporate consumer and producer behavior, as well as the interaction between other economic agents and therefore incorporate all effects on the distribution of income and economic welfare. The standardized CGE model discussed in chapter four is used to analyze the VAT issues discussed above. However, the standardized model developed by Löfgren et al (2001) does not include more than one commodity tax, and for the purpose of this analysis it is necessary to do so, as there are more than one category of commodity taxes in the South African tax system. The model was expanded to include VAT, fuel levies, excise duties, and other taxes on production.

The SA SAM commissioned by the World Bank in 2002/2003 is used as the main data source. The SA SAM is based on 2001 data and was compiled from a large number of data sources, as may be seen in chapter five. A combination of elasticities obtained from Gibson (2003), the IDC (1997), the South African CGE model of Lewis (2001), as well as the South African CGE model of Thurlow and Van Seventer (2002) are used in the CGE model. The elasticities are discussed in chapter six. The other parameters will be calibrated within the CGE model to balance and configure the model.

The following simulations were performed:

- (1) Lowering the VAT rate from 14 to 12.6 percent.
- (2) Zero-rating food. Food was first zero-rated without a revenue replacement strategy to see the impact on government savings and the rest of the economy. Secondly food was zero-rated while increasing direct taxes proportionately, and thirdly while increasing VAT on business services to absorb the loss in revenue. High-income households use business services most intensively.

- (3) Firstly, financial services were zero-rated without a revenue replacement strategy, and then secondly financial services were zero-rated while increasing direct taxes proportionately to absorb the loss in revenue.

6.2. Conclusions and Recommendations

In conclusion:

- Lowering the statutory VAT rate may generate growth and employment. However, lowering the VAT rate would result in a more inequitable redistribution of income and wealth. Lowering the VAT should be considered in combination with a revenue replacement strategy, such as an increase in direct taxes, to maintain the progressiveness of the tax structure and therefore equality.
- Zero-rating food may give immediate poverty relief, as there is a positive welfare effect. Zero-rating food should be accompanied by an increase in direct taxes to prevent government revenue from falling. The employment effects (through a decline in investment) are less severe when government savings remain constant. Increasing direct taxes will also improve the progressiveness of the tax structure.
- Zero-rating financial services led to an increase in the employment of semi-skilled labor. When zero-rating financial services while increasing direct taxes, an increase in factor income was experienced by all factors. However, zero-rating financial services will increase the regressiveness of the VAT structure, as high-income households spend the largest portion of their income on financial services. At the same time, combining zero-rating financial services with an increase in direct taxes, may maintain the progressiveness of the complete tax structure. Zero-rating financial services may also make them more accessible to poor households.

Factors that were not considered in the model are the administrative and compliance cost aspects associated with restructuring VAT or applying differential VAT rates. These however would require comprehensive surveys of registered VAT payers. Future

research may seek to obtain data on collection and compliance cost to include these aspects in the model.