B

Tax expenditure statement

Introduction

The primary aim of the tax system is to raise sufficient revenue for government spending. It can also promote socioeconomic objectives through targeted tax exemptions, deductions or credits. Tax expenditures are estimates of the total revenue foregone as a result of this preferential tax treatment. This annexure presents government's latest estimates of the fiscal cost of tax expenditures, as well as the methodology used to produce these estimates.

In 2017/18 – the latest year for which data is available – tax expenditures were estimated at R210 billion or 4.5 per cent of GDP. For that year, 35 tax expenditures were calculated compared to 34 in 2014/15, and the largest four expenditures accounted for more than half of the total. These relate to deductions for pension contributions by employers, vehicle manufacturer incentives, value-added tax (VAT) relief for basic food items and medical tax credits on contributions to medical schemes.

The effectiveness of tax incentives in meeting their stated objectives is questionable, particularly in developing countries. For example, incentives to promote investment may not materially affect decisions on whether to invest or not. Tax expenditures can also undermine the tax principles of equity and simplicity, with unintended negative consequences for the efficiency of the tax system and the broader economy. Government will continue to monitor and evaluate tax expenditures, and repeal incentives that are redundant, inefficient or inequitable.

Tax expenditure estimates

The estimates presented in Table B.2 are calculated using the "revenue foregone" method. This entails comparing actual revenue collections with revenue that would have been collected without the incentive in place.

Most of the personal income tax and corporate income tax estimates are calculated using administrative data from the South African Revenue Service (SARS), which allows expenditure estimates to be accounted for on an accrual basis.

Changes to estimation methods since the 2019 Budget

The most significant change to the tax expenditure methodology since the 2019 Budget relates to the calculation of expenditure estimates for VAT zero-rated municipal property rates.

Previously, the reported municipal property rates estimates were based on data in vendors' VAT returns submitted to SARS. In addition to zero-rated property rates, these returns include other zero-rated supplies to municipalities, as the design of the VAT return form does not distinguish between each category. This resulted in overstated tax expenditure estimates. Going forward, the tax expenditure on these property rates will be based on the audited financial statements of municipalities published on the National Treasury website. The tax expenditure estimates on VAT zero-rated municipal property rates have been recalculated for the reporting period and are now more accurately reflected in Table B.2.

The diesel refund tax expenditure estimates were understated in the 2019 Budget because they did not include the diesel refund previously offset against domestic VAT. This has been updated and estimates in the 2020 Budget are correctly reflected over the reporting period.

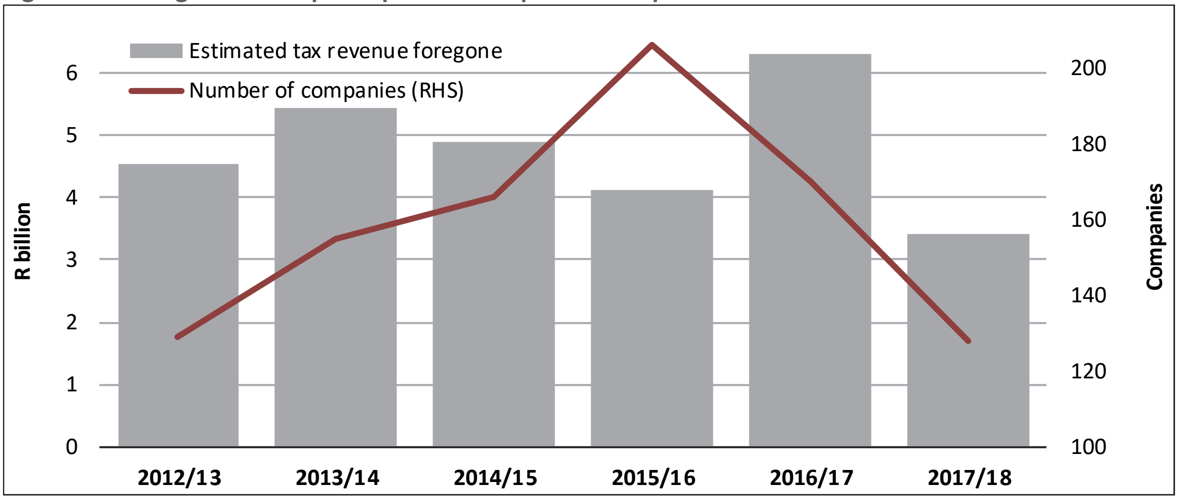
More accurate data and estimation methodologies have prompted revisions to the historical tax expenditure estimates in Table B.2. For the first time, tax expenditure estimates are published for the participation exemption for foreign dividends and the sale of equity shares, which has been effective since March 2012 through section 10B of the Income Tax Act (1962). Medical tax credit expenditures now distinguish between credits on contributions to medical schemes and for out-of-pocket expenditure.

Participation exemption in terms of foreign dividends and share sales

In line with the move from a source-based to a residence-based tax system, foreign dividends became taxable in South Africa in 2000. This shift aimed to bring South Africa closer to internationally accepted tax principles and to neutralise tax avoidance schemes. In 2012, with the move from secondary tax on companies to dividends tax, the participation exemption was introduced. To qualify for the exemption, a resident company (or group of companies) must hold at least 10 per cent of the total equity shares and voting rights of the company declaring the foreign dividend. The exemption is intended to encourage the repatriation of dividends and prevent economic double taxation – for example, if dividend withholding tax is due in the foreign country. Qualifying companies are also exempt from capital gains tax on the sale of shares.

Foreign dividends are taxable as ordinary revenue unless they qualify for the participation exemption. In 2012, a ratio was introduced to bring the effective tax rate on foreign dividends in line with taxation of local dividends. Companies that do not qualify for the participation exemption will have their foreign dividend income effectively taxed at 20 per cent (15 per cent prior to 1 March 2017), in line with local dividends.

Figure B.1 Foreign dividend participation exemption tax expenditures



Source: National Treasury

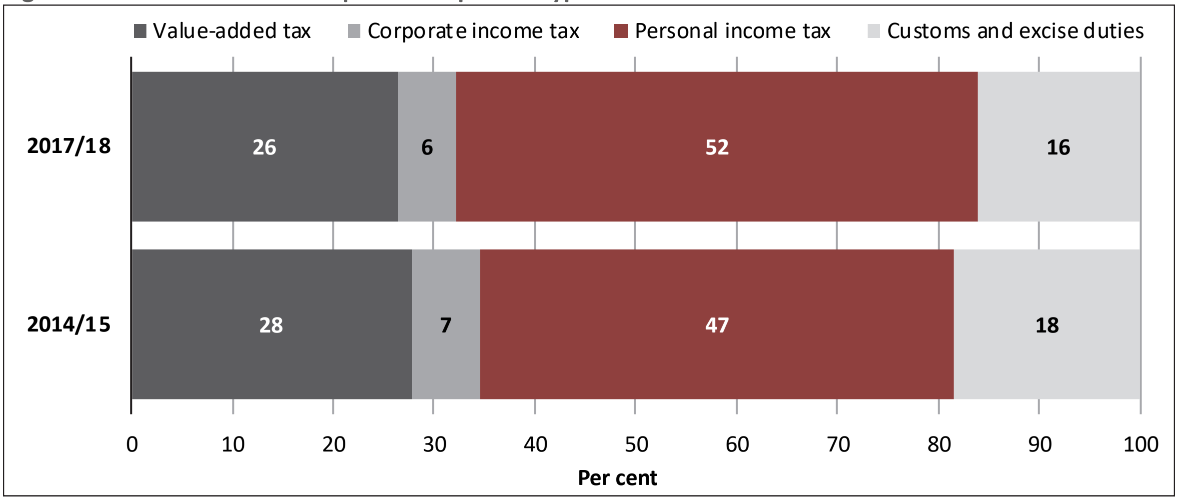
Administrative data from SARS reveals the number of companies using this exemption for foreign dividends and the rand value of the exemption (Figure B.1). Multiplying the dividend withholding tax rate by the aggregate value of the exemption provides an estimate of the revenue foregone. It is difficult to estimate the revenue that could be generated from removing the participation exemption as behaviour might change in response. Companies may be less inclined to repatriate foreign dividends without the exemption. Moreover, if the dividend was taxed at source, South Africa might not receive the full amount of dividend tax and would have to provide a credit for the amount already paid. To avoid an overestimate, the tax expenditure estimates have been adjusted downwards by one quarter over the reporting period.

The National Treasury is not yet able to calculate the capital gains tax forgone as a result of the participation exemption.

Trends in tax expenditure: 2014/15 – 2017/18

This section uses historical data to analyse trends in tax expenditure between 2014/15 and 2017/18. Including the new estimates for the participation exemption, 35 tax expenditures were estimated for 2017/18.

Figure B.2 Share of total tax expenditure per tax type



Source: National Treasury

The share of personal income tax expenditures increased to more than half of the total in 2017/18. This was the result of the significant downward adjustment to the expenditure estimates for VAT zero-rated municipal property rates, which was partially offset by the inclusion of the participation exemption expenditures for corporates. Relative to the 2019 Budget estimates, corporate income tax expenditures increased significantly between 2014/15 and 2017/18 due to the inclusion of estimates for the participation exemption. In addition, over the same period, about 20 per cent of medical tax credit expenditures were the result of eligible out-of-pocket expenditures by individuals (R4.8 billion in 2017/18).

Evaluation of tax expenditures

Government views the monitoring and evaluation of tax expenditures as an important component of ensuring transparency and accountability. As recommended by the Davis Tax Committee, government will systematically review all business tax incentives with the aim of repealing those that are redundant, inefficient or inequitable. Furthermore, government will enhance the transparency of tax expenditure reporting by investigating whether to publish a greater number of the corporate beneficiaries of incentives and the related amounts.

The 2020 Budget proposes the review of several tax incentives in 2020/21, as shown in Table B.1, to determine whether to amend or repeal them. These incentives will initially be amended by inserting sunset clauses, where none exist, indicating that they will lapse within two years. This will allow the review of these incentives to be completed before making a final decision on their future. The repeal of ineffective or distortionary incentives will expand the corporate tax base and enhance equity and efficiency in the tax system.

Besides those listed in Table B.1, other incentives without sunset clauses have been identified for future review. These incentives will be amended by inserting sunset clauses to allow for a second phase of reviews to be completed after the initial phase targeted to begin in 2020/21. This process will continue beyond the 2020 medium-term expenditure framework period until all business tax incentives have been reviewed.

Table B.1 Tax expenditures proposed for review

Income Tax Act	Effective date	Current deduction	Number of beneficiaries and tax expenditure (R million) 2013/14	2014/15	2015/16	2016/17	2017/18	Sunset clause
Section 12F	01/01/01	5% for 20 years	< 10 179.3	< 10 146.4	< 10 157.3	< 10 172.5	< 10 209.9	None
Section 12DA	01/01/08	20% for 5 years	< 5 1.0	< 10 9.6	< 5 0.1	< 5 2 726.1	< 10 2 756.1	None
Section 13*sept*	21/10/08	10% for 10 years	< 10 1.0	< 10 0.8	< 10 0.6	< 5 0.4	< 10 1.3	None
Section 12O	01/01/12	Exemption	< 10 26.4	< 10 13.9	< 10 13.2	< 10 16.2	< 10 3.1	01/01/22

Source: National Treasury

The broad criteria used to assess whether a particular incentive is justified include:

- Has it ever been reviewed?
- Does it have a sunset clause?
- Is it in line with current government objectives?
- Does it support job creation?
- How many taxpayers are claiming the incentive?
- Does its provision create unintended consequences or distortions?

It is unclear whether section 12F, which provides for a deduction for airport and port assets, is meeting its objectives. It was introduced in 2001 to promote private investment in public infrastructure. Uptake has been slow with only a few taxpayers claiming the incentive. About R600 million is claimed each year. Slow uptake may indicate that industry dynamics, beyond the scope of tax incentives, are deterring new entrants. To date, the incentive has not been reviewed and has no sunset clause.

Section 12DA provides for a deduction for rolling stock and was introduced to correct the imbalance between the capacity of the transportation network and the infrastructure demands of the growing economy. One dominant taxpayer claimed almost R10 billion in each of the 2017 and 2018 tax years, raising concerns about the equity of the corporate tax system.

Section 13*sept* provides for a deduction for the sale of low-cost residential units by an employer to its employee through an interest-free loan. It was introduced to address challenges in providing low-cost residential houses to employees by means of lease agreements. Between 2013/14 and 2017/18, few taxpayers claimed the incentive. The low tax expenditure values and number of beneficiaries implies that this incentive may not be an appropriate mechanism to achieve its objective.

Section 12O was introduced to encourage a profit-driven rather than expenses-driven approach in the filmmaking industry, after the accelerated write-off (section 24F of the Income Tax Act) was exploited. The film industry receives separate on-budget support to promote its growth and development, calling into question the need for the tax incentive, which has few claimants and is subject to lobbying for increased benefits.

Table B.2 Tax expenditure estimates

R million	2014/15	2015/16	2016/17	2017/18
Personal income tax				
Retirement fund contributions[1]	53 707	58 980	73 547	77 375
Pension contributions – employees	*13 019*	*14 363*	*15 014*	*17 008*
Pension contributions – employers	*23 882*	*26 348*	*29 064*	*31 987*
Provident contributions – employees	–	–	*3 285*	*3 947*
Provident contributions – employers	*10 087*	*11 129*	*12 303*	*13 249*
Retirement annuity	*6 718*	*7 141*	*13 881*	*11 184*
Medical	22 004	22 595	25 381	24 111
Medical tax credits on contributions[2]	*17 852*	*18 477*	*20 289*	*19 297*
Medical tax credits on out-of-pocket expenditure	*4 152*	*4 118*	*5 092*	*4 814*
Interest exemptions	2 478	2 814	3 173	3 257
Secondary rebate (65 years and older)	1 868	1 922	2 173	1 941
Tertiary rebate (75 years and older)	160	179	190	170
Donations	951	707	807	809
Capital gains tax (annual exclusion)	482	529	679	601
Venture capital companies	26	207	213	201
Total personal income tax	**81 676**	**87 934**	**106 163**	**108 465**
Corporate income tax				
Small business corporation tax savings	2 641	2 839	2 880	2 549
Reduced headline rate	*2 607*	*2 795*	*2 838*	*2 510*
Section 12E depreciation allowance	*33*	*44*	*42*	*39*
Research and development	207	277	232	150
Learnership allowances	952	1 068	1 070	568
Strategic industrial projects (12I)	423	479	690	418
Film incentive[3]	15	13	16	3
Urban development zones	232	257	273	295
Employment tax incentive	2 420	4 063	4 656	4 317
Energy-efficiency savings	135	1 057	1 192	456
Participation exemption[4]	4 907	4 122	6 294	3 421
Total corporate income tax	**11 932**	**14 175**	**17 304**	**12 176**

Table B.2 Tax expenditure estimates *(continued)*

R million	2014/15	2015/16	2016/17	2017/18
Value-added tax				
Zero-rated supplies	47 002	47 941	50 521	54 254
19 basic food items [5]	*21 503*	*22 793*	*24 411*	*26 023*
Petrol [6]	*16 065*	*15 901*	*16 150*	*17 080*
Diesel [6]	*2 146*	*1 911*	*1 842*	*2 049*
Paraffin [6]	*659*	*536*	*569*	*665*
Municipal property rates	*6 402*	*6 567*	*7 285*	*8 130*
Reduced inclusion rate for commercial accommodation	*228*	*233*	*263*	*307*
Exempt supplies (public transport and education)	1 256	1 332	1 426	1 520
Total value-added tax	**48 259**	**49 273**	**51 947**	**55 774**
Customs duties and excise				
Motor vehicles (MIDP/APDP, including IRCCs) [7]	23 467	26 936	28 362	28 754
Textile and clothing (duty credits – DCCs) [7]	539	788	725	712
Furniture and fixtures	180	217	181	198
Other customs [8]	911	1 040	963	875
Diesel refund [9]	6 900	9 283	5 037	3 025
Total customs and excise	**31 997**	**38 264**	**35 268**	**33 564**
Total tax expenditure	**173 863**	**189 646**	**210 682**	**209 979**
Tax expenditure as % of total gross tax revenue	**17.6%**	**17.7%**	**18.4%**	**17.3%**
Total gross tax revenue	**986 295**	**1 069 983**	**1 144 081**	**1 216 464**
Tax expenditure as % of GDP	**4.5%**	**4.6%**	**4.8%**	**4.5%**

1. Some of this tax expenditure is recouped when amounts are withdrawn as either a lump sum or an annuity. From 2016/17 onwards provident fund employee contributions became deductible and a higher percentage contribution for all retirement funds was allowed, alongside a monetary cap of R350 000. The estimate for the tax expenditure of provident fund employer contributions (for all years) was included for the first time in the 2019 Budget
2. Medical credits were introduced in 2012/13 to replace income tax deductions for medical scheme contributions
3.Tax expenditure for all years is attributable to allowances under section 24F and exemptions under section 12O
4. Tax expenditure only attributable to foreign dividends. Capital gains tax on share sales not included
5. VAT relief in respect of basic food items based on 2010/11 Income and Expenditure Survey data
6. Based on fuel volumes and average retail selling prices
7. Motor Industry Development Programme (MIDP), replaced in 2013 by the Automotive Production Development Programme (APDP); import rebate credit certificate (IRCC); duty credit certificates (DCC)
8. Goods manufactured exclusively for exports, television monitors and agricultural goods exempted
9. Diesel refund previously offset against domestic VAT has been added
Source: National Treasury