

# Various options using VAT to raise revenue

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25 Feb 2015

The Finance Minister has various options at his disposal concerning how he could use VAT as a fiscal instrument to raise revenue and reduce the budget deficit that has occupied the brain trust in government.



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South Africa's VAT rate has been constant since 1993 when it was raised from 10% to 14%, and it is also relatively low compared to international standards. Emerging markets average at approximately 18%, whereas developed countries average at approximately 17%.

## Increasing the VAT rate

Many economists may support a 1% increase in the VAT rate which will take it to 15%. Such a step will go a long way towards reducing or even eradicating the R15bn budget shortfall, except where the gap increases even further.

Increasing the VAT rate by 2% is very unlikely as it could be perceived to be inflationary and will definitely find political opposition. It should be noted that although a VAT rate increase may have a perceived inflationary effect, this might in pure economic theory not be true as inflation measures the year-on-year increase or decrease in the price of an average household basket of goods and services (excluding or including interest), which effectively means that any potential inflationary effect is wiped out after the first twelve months as a VAT rate increase would be a once-off.

An increase in the VAT rate may have at least initial, adverse cash flow consequences for business as most businesses account for VAT on the invoice basis. A vendor is still required to pay VAT over to SARS on credit sales even though it has not received payment yet.

## Multi-tier VAT rate system

Some observers have put forward the introduction of a multi-tier VAT rate (over and above the standard 14% and 0% rate), with a higher rate on so-called luxury goods and services. The downside is the increased administration and compliance costs and may not be worthwhile considering the cost-benefit.

A further downside is that experience has shown that a multi-tier VAT rate could lead to lobby groups which could eventually place the very existence of a sound VAT base under siege. A further disadvantage is that a multi-tier VAT rate has the potential to increase fraud as vendors could manipulate the VAT rate classification when on-selling, whilst claiming the higher VAT credits on acquisition. The Katz Commission also considered - but eventually rejected - a multi-tier VAT system several years ago.

A multi-tier VAT rate system also may have a distortionary effect on consumption or expenditure as it favours certain commodities while discriminating against others. As a result, being content with the current two tier VAT rate system therefore seems the most logical answer (namely 14% and 0%).

## **Narrowing zero rate application**

Narrowing of the application of the zero rate could potentially generate more revenue. Such a step could be seen to increase the theoretical purity of the VAT system and purely theoretically should be welcomed since a wider VAT base favours administrative, compliance, and evasion perspective. It could also be argued that a base broadening could, again at least in theory, be spent far more directly and used to alleviate the plight of the poor. South Africa would, however, need to ensure that it has the required infrastructure to provide this relief.

The downside is that such a step may receive political opposition and would have to be carefully considered before implantation. The Minister may do well to commission a group of experts to relook the zero rates (excluding exports) currently afforded under the VAT system and the regressive nature of a possible VAT imposition thereon as the current basket of zero rated goods may not necessarily reflect the consumption patterns of the poor.

## **Where to from here?**

The three options considered above could all potentially raise additional revenue for the fiscus, to a greater or lesser extent. However, government would probably be ill advised to introduce a multi-tier VAT rate to place an additional tax on luxury goods and services. The Minister could potentially rather consider an increase in the VAT rate by 1% taking it up to 15%. Further consideration should definitely also be given to a narrowing of the zero rating base, preceded by an extensive scientific economic study on consumption patterns of the poor and the current zero rate applied to foodstuffs.

## **ABOUT THE AUTHOR**

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