United Nations University
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Session 8:
Ex-Post Evaluation of TEs I

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Introduction

- In South Africa, for the 2020/21 fiscal year, the cost of tax expenditures was estimated at 4.5% of GDP. The TE from PIT accounts for 57% of total TEs.
- The two main personal income tax expenditures are retirement contribution deductions and medical tax credits, accounting for 69% and 25%, respectively
- The initial design of personal income tax expenditures does not necessarily provide optimal distributional gains. One example is the previous medical tax deductions in the South African tax system (converted to a tax credit in 2012).
- **Research Question:** Are redistributive gains possible by restructuring tax deductions such as retirement contributions?

Forthcoming Research paper by Prof. Ada Jansen (Stellenbosch University), Winile Ngobeni and Wynnona Steyn (SARS)

Tax Expenditure example from South Africa: Retirement contributions

The allowable PIT tax deduction is the lesser of the following options:

- R350 000; or
- 27.5% of the greater of
  - remuneration (excluding benefits) or
  - taxable income (including passive income and taxable capital gains), but excluding benefits or
  - taxable income (excluding any taxable capital gain and benefits.

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Retirement contribution deductions

- 7 million taxpayers claimed Retirement contribution deductions = R275 billion
- Close to 48% of taxpayers with taxable income contributed towards retirement funds.
- Tax expenditure cost amounted to R91 billion or 17% of total final tax liability.
- The benefit of a tax deduction at a marginal tax rate of 45% (SA top tax rate) is high in relation to taxpayers who contribute closer to the average retirement contribution deduction at a marginal tax rate of 26% - a regressive outcome.
  - The lower the income, the lower the % of the contribution
  - The higher the income, the higher the % of the contribution.

Method: Microsimulation Model “PITMOD”

- The PITMOD microsimulation model is a static microsimulation model using anonymized South African PIT data provided by the South African Revenue Service (SARS).
- The retirement contribution reform options are simulated based on the 2019/20 tax year (latest tax administrative data available).
- The distribution of registered individuals with income below and above the minimum tax thresholds is included in the analysis.

Some notes about the model:

- Developed through collaboration between SARS, SASPRI and UNU-WIDER
- Challenges of developing PITMOD: a large set of Income codes required, very detailed PIT rules
- ➢ Policy and system functions are defined, and each function is divided into a series of parameters.

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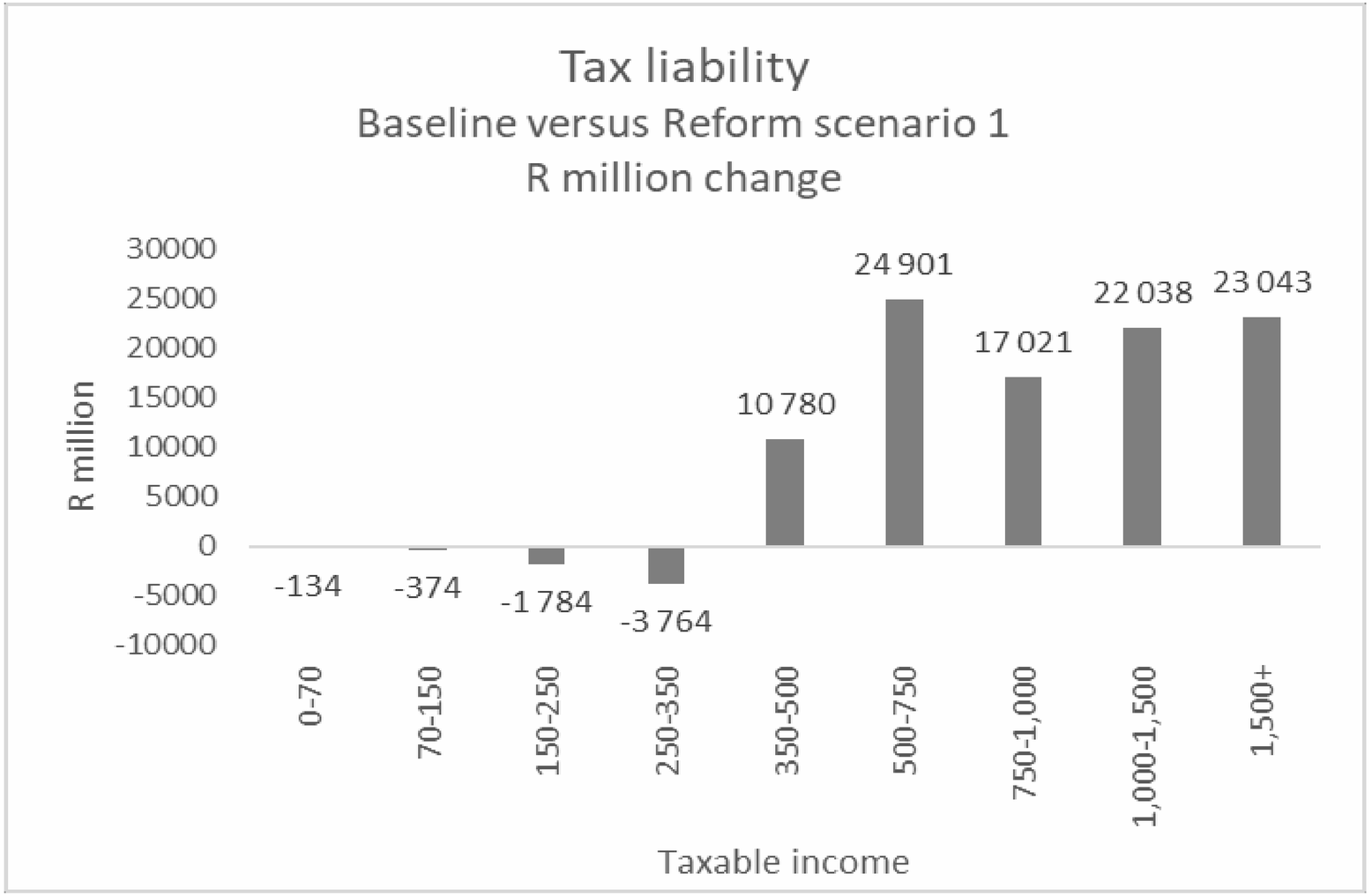
Policy change options -

- Reform scenario 1: Abolishment of retirement contribution tax deductions

- Reform scenario 2: Conversion of retirement contribution tax deductions to tax credits
  - Three conversion rates were applied (to allowable retirement deductions):
    1. 35% tax revenue neutral conversion rate
    2. 26% average contribution conversion rate (marginal rate of the 2nd income bracket)
    3. 31% conversion rate (marginal rate of the 3rd income bracket)

Results from Scenario 1: Abolish the deduction

- There is an upward shift of taxpayers on the taxable income scale
- Taxable income increases by R274.8 billion.
- For those earning R500k-R750k, taxable income increased by 2.1 percentage points.
- Final tax liability increases by 16.9%.



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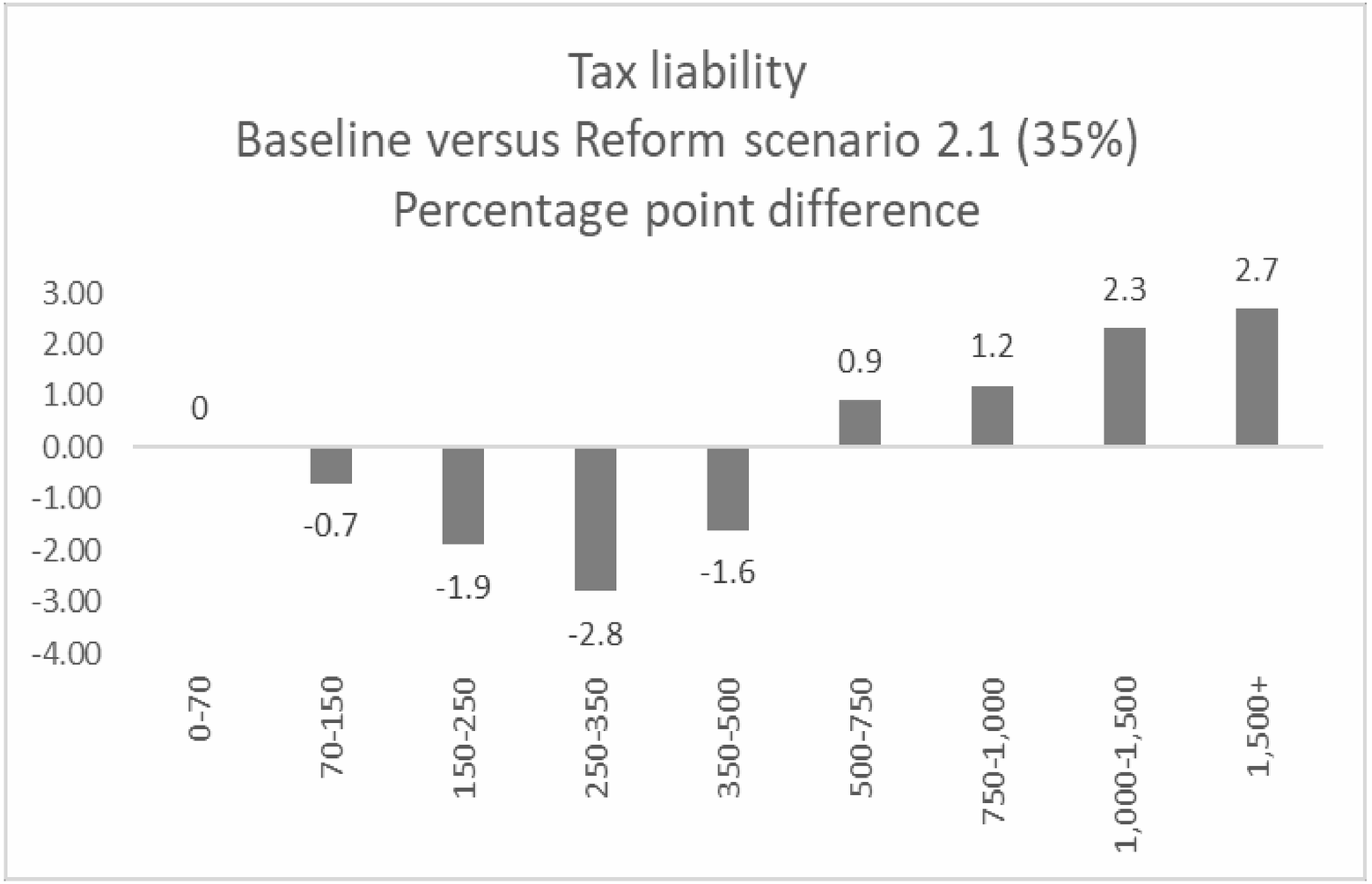
Results from Scenario 2.1: From Deduction to Tax Credit at 35% rate



- A revenue-neutral reform scenario benefits taxpayers with taxable income less than R500k
- Taxpayers in the R250k-R350k group benefit the most with a decrease in their tax liability of 2.8%.
- This scenario, the PIT system becomes more progressive, with the GINI coefficient for final tax liability increasing from 85.2 to 86.0.

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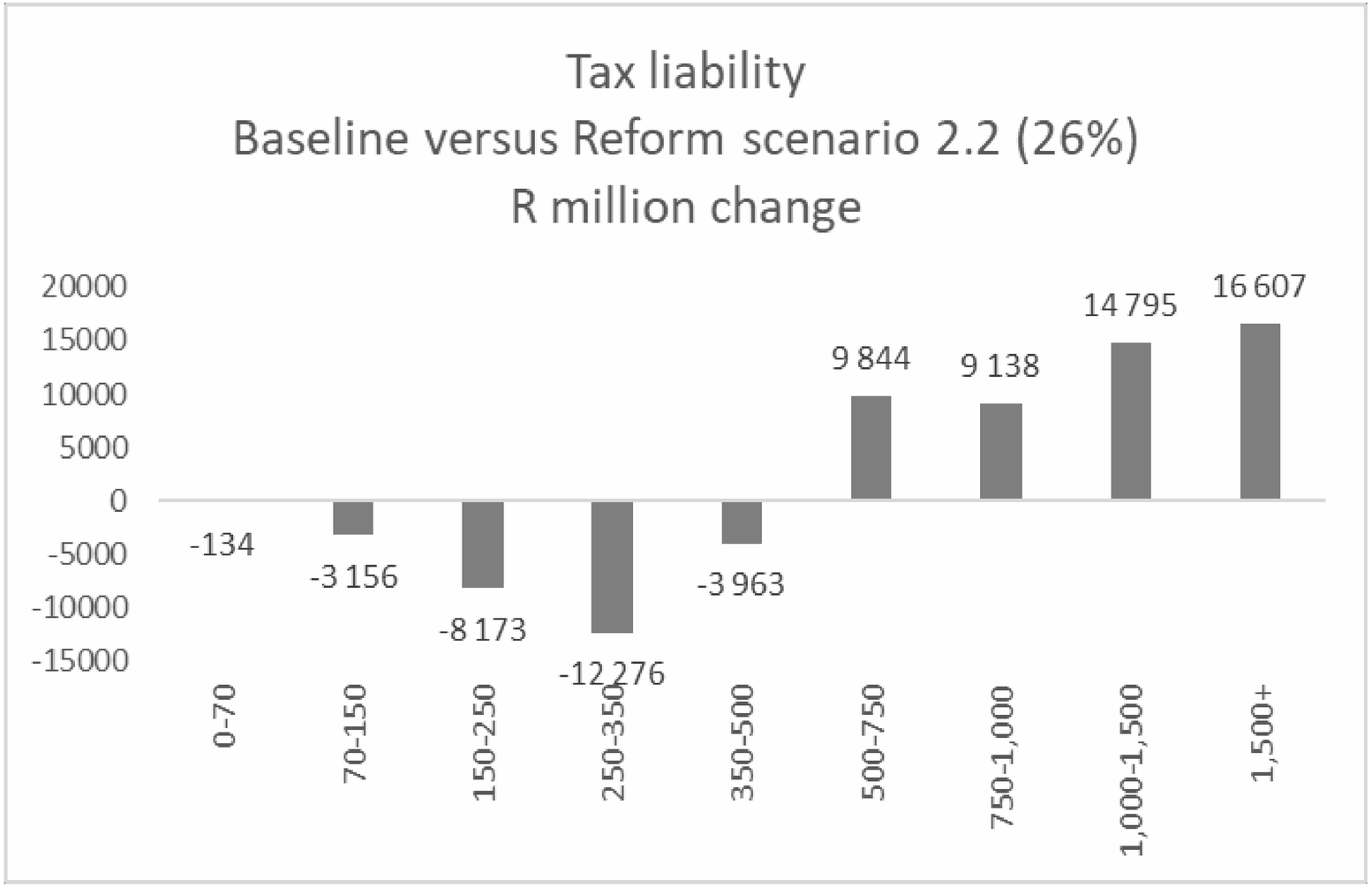
Results from Scenario 2.2: From Deduction to Tax Credit at 26% rate



- Total taxable income increases by R274.8 billion and final tax liability by 4.2%.
- The average final tax liability is reduced for taxpayers with taxable income less than R500 000 annually.
- Most of the increase in average tax liability is borne by taxpayers earning more than R1 million
- In this reform scenario, the PIT system becomes more progressive, increasing the GINI coefficient from 85.2 to 85.5.

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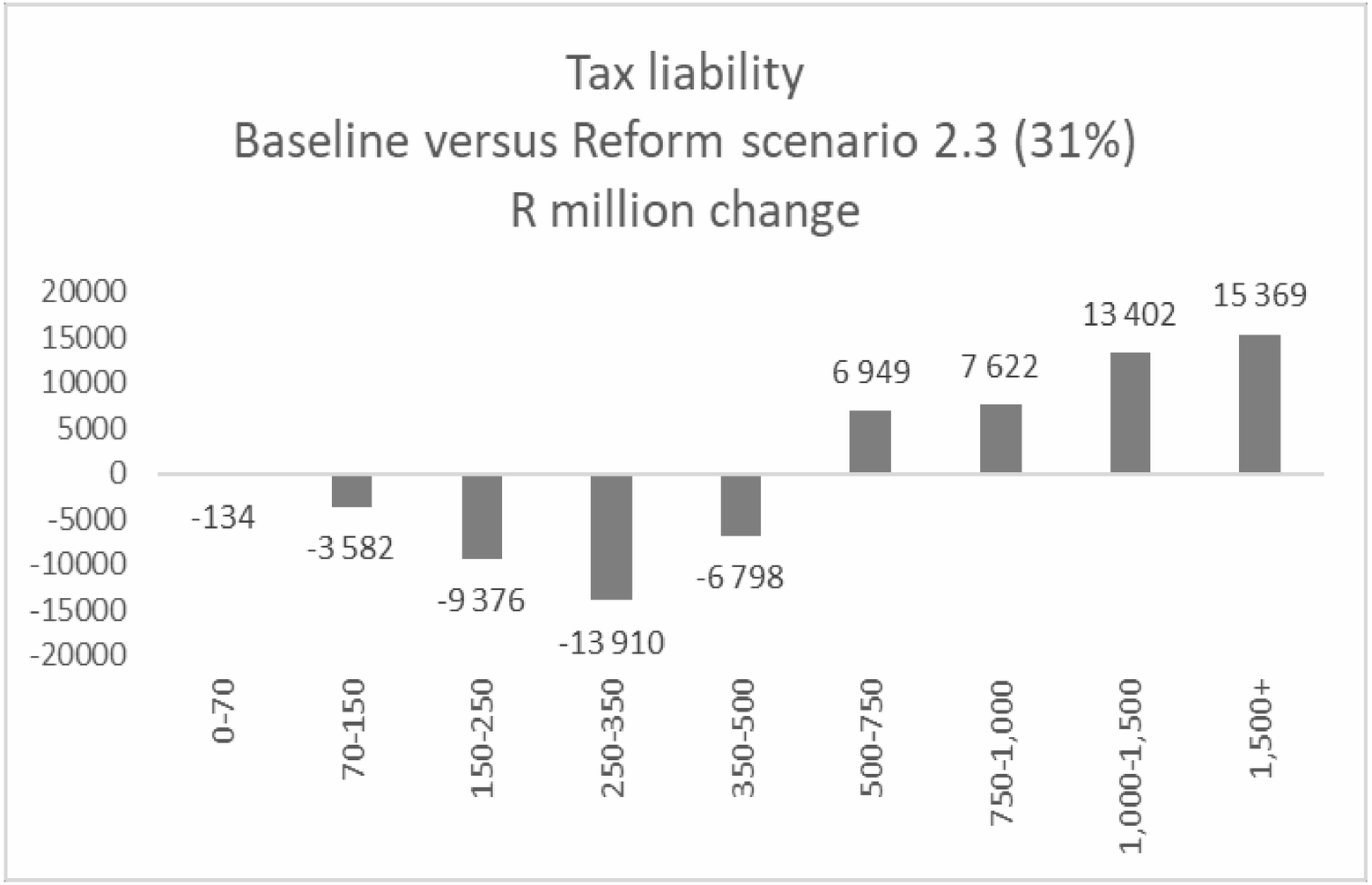
Results from Scenario 2.3: From Deduction to Tax Credit at 35% rate



- Final tax liability increases by R9.5 billion (more taxpayers benefitting from the higher conversion rate compared to the 26% conversion rate).
- The average tax liability of taxpayers with taxable income less than R500,000 per annum is reduced.
- The GINI coefficient for final tax liability increases by 0.6 to 85.8, increasing the progressivity of the PIT system by a higher percentage than Scenario 2.2

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1. The tax deduction benefits higher-income earners taxed at higher marginal tax rates.

2. Switching to a tax credit system is more effective at the 26% conversion rate with a net revenue outcome of R22.7 billion or an increase in tax revenue of 4.2%.

3. A 26% conversion tax credit system may protect low-income earners from increased tax liability and reduce the tax liability of low-income earners contributing to pension funds.

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Take-aways

- Tax systems are designed to **raise revenues** efficiently to finance government spending.
- Nonetheless, the tax system is used to attain socio-economic objectives such as a more **equitable** distribution of income or to incentivise specific outcomes.
- Tax expenditures are used to achieve such goals and refer to the preferential treatment of such expenditures in the tax system.
- The government's indirect approach to incentivise the provision for old age by allowing a tax deduction for retirement contributions may seem *costly* in terms of tax revenue forgone of R91.7 billion
- We may be tempted to say that all Tax Expenditures are bad or that we should remove or reduce them, but in this case, it may be justified given the shallow savings rate and potential burden on the state to provide for many more citizens in their old age.

Thank you!

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