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BUSA SUBMISSION TO THE DAVIS TAX COMMITTEE ON POSSIBLE WEALTH TAXES FOR SOUTH AFRICA

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Background

BUSA is a confederation of business organisations including chambers of commerce and industry, professional associations, corporate associations and unisectoral organisations. It represents South African business on macro-economic and high-level issues that affect it at the national and international levels. BUSA's function is to ensure that business plays a constructive role in the country's economic growth, development and transformation and to create an environment in which businesses of all sizes and in all sectors can thrive, expand and be competitive.

As the principal representative of business in South Africa, BUSA represents the views of its members in a number of national structures and bodies, both statutory and non-statutory. BUSA also represents businesses' interests in the National Economic Development and Labour Council (NEDLAC).

Introduction

In order for South Africa to achieve inclusive growth to address the triple challenges of unemployment, poverty and inequality, a fair and efficient revenue collection system and appropriately designed tax policies are critical. The objectives associated with a wealth tax in the South African context, such as promoting social cohesion, inclusion and reducing poverty are therefore beyond contention. What is open to contention however is the optimal means to fund government expenditure within the overall framework of the existing tax

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system and structure. From this perspective, BUSA is not in favour of additional taxes on wealth in the current context.

It is worth noting that the current taxes on immovable property are levied in South Africa:

- Capital gains tax on the disposal of immovable property;
- Transfer duty or Value Added Tax (VAT) on the purchase of immovable property; and
- Municipal property rates, levied by local government.

Along with donations tax, these constitute existing taxes on wealth in the South African context. This submission examines the potential impacts of additional taxes on wealth.

A land tax

BUSA understands the above to refer to the value of unimproved land, distinct from a property tax which taxes the value of land together with improvements thereto. Notwithstanding the theoretical arguments in favour a land taxes, including *inter alia* the fact that economic efficiency and productive use of land is encouraged through such a tax, there are significant practical and economic reasons as why a land tax would be harmful. In our view, these practical and economic considerations imply that a land tax would be counter-productive to the realisation of South Africa's social, economic, revenue and fiscal considerations.

A narrow tax base

The overall tax-to-GDP ratio for South Africa stands at around 30% if one includes indirect taxes. South Africa now has one of the highest levels of taxation globally when social security taxes are excluded, with taxation levels on an upward trend. The challenge with this level and trajectory from the point of view of BUSA is the fact that this rests on a relatively small group of individual and corporate taxpayers. What is often overlooked in the overall analysis is that 62% of Personal Income Tax (PIT) is paid by less than 600 000 taxpayers (roughly R241 billion). With regard to Corporate Income Tax (CIT), South Africa is similarly disproportionately reliant on large corporates, with 64% of all CIT paid by fewer than 620 companies (roughly R109 billion). A key inference to be drawn from this is the fragility of South Africa's revenue stream, with a limited range of options available, given the narrow tax base, for increasing revenues without possible consequences in terms of reduced levels of compliance.

Challenges associated with administration

A land tax would require a reliable national list of all immovable properties as well as a common method of valuation. In addition, decisions around exclusions (e.g. communally or government owned land) would need to be made. South Africa does not currently have a national system of valuation; rather valuation rolls are maintained by municipalities and are informed by different valuation methodologies. A national tax would therefore require in effect a national system of valuation, which simply does not yet exist. Furthermore, administrative shortcomings in the current municipal rates regime in South Africa is well documented. Any shortcomings in the current rates regime at municipal level are therefore at the very least likely to be replicated in a land tax at the national level, including the inability of many municipalities to collect revenue owing. There would in addition be annual administrative costs related to revaluation processes, which would in part undermine the revenue-raising potential of the tax.

Effect on land values

Notwithstanding the aforementioned problems pertaining to valuation, a land tax invariably results in a reduction in the economic value of land. Existing owners of land, as well as lenders and investors would be affected by such changes, particularly in cases where the land itself is already highly geared. Moreover, in cases where the land itself is used as collateral to secure loans for improvements, the existence of a land tax may inhibit owners' ability to secure loans. The overall impact on the economy and financial system could potentially be profound and would require careful consideration and consultation before introduction.

Liquidity concerns

A frequent observation of opponents of wealth taxes, often quite rightly, is that owners of wealth may be "asset rich, cash poor", i.e. may be owners of wealth but nonetheless have limited liquidity to pay applicable taxes.

The elderly, rural poor (such a small landholders / subsistence farmers), small business owners growing a business and highly leveraged borrowers among others often fall into this category. In extreme cases, the unintended result is the forced selling of the asset itself. This is particularly problematic in the South African context, where emerging entrepreneurs often experience liquidity constraints in the early, expansion phases of their businesses.

The negative impact on transformation

As indicated above, a land tax would have problematic effects on transformation, not only for such categories as emerging entrepreneurs and small rural landholders faced by liquidity constraints but also potentially - depending on its design – work against the land reform process as well as transformation in the housing market. Therefore, although the revenue-generation aspects of a land tax may have a limited positive effect on transformation, there are at the same time also potential and immediate negative effects on transformation.

Potential effect on agricultural productivity

In a study conducted by Darroch, Lee and Ortmann[1] a correlation was made between increased land taxes and decreased international competitiveness of the South African agricultural sector. A correlation was also made between increased taxation and decreased capital investment into the land. The South African agricultural sector competes in a globalised economy against countries that receive significantly more state support than that provided to South African farmers. The South African agricultural sector is characterised by small margins as our input costs are relatively high due a weak currency and a reliance on the importation of certain inputs. The sector is therefore forced to make use of scale economies to compete in markets where other producers receive input and other subsidies. In short then, the sector remains internationally competitive by increasing the land under production so that fixed costs can be spread out over a larger production area. Relatively large land ownership in the agricultural sector should therefore not automatically be seen as a sign of wealth, but rather as a necessity to sustain an internationally competitive industry. Other sectors in the

[1] MAG Darroch, RB Lee and GF Ortmann. 2008. The Economic Impact of a Rural and Land Ta on Selected Commercial Farms in Kwa-Zulu Natal, South Africa. *South African Journal of Economic and Management Sciences.* Vol 11 no. 3. Pretoria

economy can attain higher profit margins (a more accurate sign of wealth) without land ownership, and as such we believe that additional land tax as a form of wealth tax is misplaced.

Should additional taxes be levied over agricultural land, it will increase the cost of production and reduce the sector's competitiveness, which will in turn harm the agribusiness sector. The increase in revenue collected through a land tax may therefore be off-set by a reduction in the agricultural and agribusiness sector as a tax base. What this demonstrates is the complex interplay between taxation and economic competitiveness in a specific sector, in this case a sector of disproportionate importance to rural employment and the employment of un- and semi-skilled labour, with the highest sectoral employment multiplier effect in the country. Any negative impact on a sector as important to the overall economy and social compact as agriculture should therefore be avoided.

Potential effect on the price of consumer goods and the basic cost of living

As per the discussion above, increased taxes on land would amount to an increased input cost of production which producers will have to off-set somehow. The most likely scenario would be for prices to increase and the nett effect would be that the price of consumer goods and the basic cost of living would rise. This would disproportionately affect lower and middle-income households, an outcome that a land tax as a form of wealth taxation surely does not strive to do.

A national tax on the value of property (additional to municipal rates)

BUSA understands the above to refer to a recurring tax on the value of land, including improvements on it. A key rationale for a tax on the value of property is that the better off automatically pay a greater proportion and that there are therefore clear equity considerations in favour of the tax. However, the aforementioned concerns and challenges related to the imposition of a land tax are similarly applicable to a national tax on the value of property and will not be repeated in this section. What is perhaps worth mentioning is the additional unintended consequence pertaining to a tax on the value of property in that owners of property (both commercial and residential) may inadvertently be discouraged from investing in and improving their properties. In simple terms, any investment in improvement would be in part undermined by increases taxes owing to the improvements in the property. In effect, the maximising of productive capacity would be undermined by such a tax. As such, the tax would be contrary to the principles of land improvement and would indeed serve as a disincentive to improve land, particularly in sectors such as mining and agriculture.

An annual wealth tax

BUSA understands an annual wealth tax to refer to an annual tax on the holding of wealth, as distinct from taxes on the transfer of wealth (the latter are already levied in South Africa, such as donations tax, estate duty, etc.). Aside from the revenue-raising potential of the tax, much of the attraction appears to reside in its theoretical ability to reduce wealth inequality. In South Africa, the Gini coefficient for wealth is 0.95 – considerably greater than the highly unequal nature of income inequality with a Gini coefficient of slightly less than 0.7. The idea of an annual wealth tax has gained considerable momentum since 2014 and the publication of *Capital in the Twenty-First Century* by Professor Thomas Piketty. Notwithstanding the arguments put forward by both advocates and opponents of Piketty's work, BUSA does not support the introduction of an annual wealth tax in the South African context for the following reasons:

The effect on savings

An annual wealth tax would inadvertently serve as a disincentive to saving in context where South Africa's notoriously low rate of savings (less than 16% of GDP) acts as a major constraint to economic growth. South Africa's savings rates militate against capital formation and investment and are low by international standards, particularly when compared to, for example, our partners in BRICS. In this context, every effort to encourage savings should be pursued. Unfortunately, an annual wealth tax would send the opposite message to potential savers, making real returns after inflation and taxes harder to achieve. Moreover, savings are often funded by earnings – particularly for the historically disadvantaged with limited accumulated assets – implying taxation at the point of income earnings as well as on the wealth derived therefrom. Depending on the rate of the wealth tax, income tax bracket, inflation and the rate of return, savings could be subjected to unacceptably high levels of taxation and unacceptably low rates of return, thereby discouraging saving. In short, the tax would discourage savings and encourage consumption, and would therefore be contrary to government policy to encourage savings.

The effect on entrepreneurship

Many entrepreneurs, aspiring or otherwise, pursue the risks inherent in entrepreneurship for the perceived potential benefits of wealth accumulation. Growing entrepreneurship, particularly in SMMEs, is an important avenue of potential economic growth. In South Africa, smaller businesses contribute only 65% to overall employment, relative to a worldwide average of 95%. The potential to add many small and growing businesses, particularly those controlled and operated by historically disadvantaged individuals is an obvious avenue through which to activate inclusive economic growth. However, an annual wealth tax would create a disincentive to embark on entrepreneurship. In addition, an annual wealth tax would fail to make allowance for upward or downward shifts in the economic cycle and potentially render an annual wealth tax difficult to pay under certain conditions.

The effect on the economy

International studies that have sought to measure the economic impact of wealth taxes as proposed by Piketty have shown significant likely negative effects. An influential study[2] on the potential effects of a wealth tax of 1-2% in the USA showed a reduction in the capital stock of 13.3%, a decrease in wages of 4.2% and significant job losses and economic contraction. In such a scenario, losses would be economy-wide and undermine the perceived equity-promoting characteristics of the tax.

[2] Schuyler, Michael, The Impact of Piketty's Wealth Tax on the Poor, the Rich, and the Middle Class, Tax Foundation, 2014

Liquidity constraints

The earlier comments around liquidity constraints in relation to taxes on immovable property are similarly relevant to an annual wealth tax. In many cases, the returns generated by the possession of wealth would not be sufficient to pay the tax. In extreme cases, the disposal of the asset is the only recourse for the taxpayer.

Risk of capital flight

On the back of credit downgrades from the three major ratings agencies, a policy framework that is not conducive to investment spurred on by uncertainty regarding property rights and commitment to trade agreements, South Africa runs the risk of warding off investment in the country, both foreign and domestic. Based largely on such uncertainty, business confidence is sub-optimal and uncertainty around taxation – particularly the prospect of additional taxes – adds to existing levels of uncertainty. Should wealth taxes be raised even further and additional taxes on the value of property be introduced, there exists a serious risk that investors will move capital out of the country. The nature of a modern, globalised economy means that capital can now move in and out of national boundaries with relative ease. Liquid capital held by multinational companies can easily be moved and tax havens (such as Mauritius) can replace South Africa as a springboard into Africa.

The effect on compliance

The earlier comments around the narrowness of South Africa's tax base are pertinent in the sense that overall levels of compliance – much improved in recent years – may very well be adversely affected by the introduction of an annual wealth tax. It is important to note that capital in particular is highly mobile, notwithstanding efforts in recent years to improve international coordination in tax collection. Capital flight, evasion, the growth in the cash economy, as well as loss of human capital are some of the unintended consequences often associated with the introduction of wealth taxes.

Administrative challenges

Assets, particularly in forms of wealth such as shares in unlisted companies, personal effects (e.g. art) are notoriously difficult to value, and could serve to unfairly target forms of wealth that are easier to tax. The earlier comments in relation to administrative challenges in valuing immovable property also apply.

The international experience

It is worthwhile to note that few countries internationally levy an annual tax on wealth, with many countries exploring the possibility and deciding against it, and others abandoning an annual wealth tax, the latter citing the low yield, administrative costs and capital flight associated with the tax.

Conclusion

For more detailed submissions on the objections to and the challenges associated with the introduction of additional wealth taxes in South Africa, BUSA would like to refer the DTC to the detailed submissions of its members. Additional wealth taxes would appear to be a short-term revenue-raising measure that would have harmful long-term social and economic consequences. To reiterate, additional wealth taxes:

- Are likely to discourage savings and spur consumption;
- May reduce investment (both fixed and portfolio investment);
- Are likely to result in capital flight;
- Are likely to encourage tax avoidance and non-compliance.

Overall therefore, and for the reasons outlined in this submission, BUSA is not in favour of the introduction of additional wealth taxes in South Africa in the current context.