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Research Submission on

The Fiscal Impact of a Basic Income Grant in South Africa

submitted to the
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EXECUTIVE SUMMARY

The net cost of *Basic Income Grant* transfers would be R23.9 billion. The *Basic Income Grant* therefore represents a substantial commitment of fiscal resources. However, a well-managed programme is affordable and consistent with fiscal responsibility. South Africa's tax structure has the potential to finance the entire cost of the programme without recourse to deficit spending.

The *Basic Income Grant* is likely to promote economic growth through raising overall national income. The overall net cost of the *Basic Income Grant* transfers is likely to be lowered over time, as recipients of the *Basic Income Grant* gradually move to income levels in which their net transfer is reduced.

The *Basic Income Grant* also supports more efficient social services. The *Basic Income Grant* is likely to reduce the cost pressure on several social sectors, resulting in a reduction in the net fiscal impact of the grant. The long-term growth implications of the developmental impact further supports macroeconomic stability and fiscal affordability.

1. INTRODUCTION

The high cost and coverage gaps resulting from South Africa's social security system motivates the need to consider alternative social assistance programmes. One alternative to the current grant system (which is based on the means test) is the *Basic Income Grant*. In contrast to the means test, which selects a target group of eligible beneficiaries, the *Basic Income Grant* would provide social assistance to all South Africans.

Research findings indicate that the extension of a *Basic Income Grant* could potentially induce positive socio-economic effects, for example, the universal nature of the *Basic Income Grant* would prevent coverage gaps and improve social protection.[1]

In light of the social and economic viability of a *Basic Income Grant*, this paper aims to assess the fiscal viability of the grant. Specifically, the paper analyses the fiscal impact, evaluating the affordability of the *Basic Income Grant* and its impact on government finances.

The paper is divided into an introduction, four main sections and a conclusion. The first main section evaluates the magnitude of the fiscal impact. The following three sections evaluates the fiscal impact of a *Basic Income Grant* through the analysis of various fiscal measures, namely government expenditure (Section 3); tax revenue (Section 4) and fiscal deficit (Section 5). Section 6 provides a conclusion.

1 For more information about the social impact and economic impact of the *Basic Income Grant*, see Samson *et al (*2001b) and Samson *et al* (2001c).

2. MAGNITUDE OF THE FISCAL IMPACT

A major factor affecting the feasibility of a *Basic Income Grant* for South Africa is the question of affordability. The fiscal costs of the *Basic Income Grant* are substantial. The magnitude of the fiscal impact depends on several factors:

- The size of the grant.
- The associated adjustments to the income tax structure.
- The growth effects resulting from the improved living standards.
- The impact of the grant on other government expenditures.
- The take-up rates for the grant.

2.1 THE SIZE OF THE GRANT

The size of the *Basic Income Grant*, together with the demographic assumptions and the extent of existing social security programmes, determines the gross cost of the income transfers associated with the *Basic Income Grant*. Estimations of the South African economy indicate a total population in March 2001 of 44.9 million people, of which 8.4 million people are eligible for existing social security programmes.[2] Assuming a *Basic Income Grant* of R100 per month, the gross cost of the income transfers would be R43.8 billion.

2.2 THE ASSOCIATED ADJUSTMENTS TO THE INCOME TAX STRUCTURE

Out of the R43.8 billion gross cost of the *Basic Income Grant*, people in the top three quintiles of the population receive R22.2 billion. Adjustments to the income tax structure can recuperate most of these transfers without significantly affecting the vertical equity of the net tax burden. Adjusting the tax rates and income thresholds at

2 The population was estimated using a household-level micro-simulation model. For more information about the technical modelling, see Samson *et al* (2001a).

lower income levels gradually recuperates the *Basic Income Grant* from middle- and upper-income earners. The VAT, in turn, recuperates a significant portion of the expenditure associated with the net transfers. Micro-simulations of various tax adjustment options yield an average recuperation of R16.7 billion through the income tax, and R3.3 billion through VAT. This results in a net cost of the *Basic Income Grant* transfers of R23.9 billion.

2.3 THE GROWTH EFFECTS RESULTING FROM THE IMPROVED LIVING STANDARDS

The *Basic Income Grant* is likely to promote economic growth through a number of important transmission mechanisms, including:

- **The labour market***:* increased labour supply and demand raises employment levels and supports economic growth.
- **Social capital**: maintaining proper nutrition and providing education raises the productivity of labour and capital and fuels economic growth and job creation.
- **The macro-economy**: increased aggregate demand levels and changes in the composition of demand promote higher rates of growth and employment.

Precise quantifications of the magnitude of the growth effects are difficult to substantiate, but the analysis in this section models two assumptions:

- A conservative growth assumption of an additional 1% of growth associated with the *Basic Income Grant*.
- A more aggressive growth assumption of an additional 2% of growth.

Growth has two effects on the fiscal impact of the *Basic Income Grant*. First, it raises overall national income, and thus supports the capacity of the economy to support fiscal expenditure. Second, by concentrating growth on lower income individuals, recipients of the *Basic Income Grant* gradually move to income levels in which their net transfer is reduced. This lowers the overall net cost of the *Basic Income Grant* transfers over time.

2.4 THE IMPACT OF THE GRANT ON OTHER GOVERNMENT EXPENDITURES

Just as the *Basic Income Grant* has a positive impact on economic growth, it also supports more efficient social services. Higher living standards raises the efficiency of the educational system, reducing the repeat rate and thus economising on educational resources. Improved nutrition raises lifetime health levels, reducing the strain on the public health system. The medium- to long-term impact of the *Basic Income Grant* is likely to reduce the cost pressure on several social service sectors, resulting in a reduction in the net fiscal impact of the grant.

2.5 THE TAKE-UP RATES FOR THE GRANT

The take-up rates of the grant determine the dynamic impact of the programme. Historically, planning of social security programmes in South Africa has over-estimated the take-up rates. Take-up rates are largely a function of administrative capacity and political will. Aggressive outreach campaigns can substantially improve take-up rates, particularly when co-ordinated with aggressive improvements in bureaucratic capacity.

The government's concern with fiscal impact manifests itself through several macro-economic indicators. The latest Budget Speech by the Minster of the National Treasury emphasised the need for constraint in overall government expenditure. Other measures of fiscal impact include the budget deficit and overall level of taxation. The following analysis evaluates the fiscal impact of the *Basic Income Grant* in line with these fiscal parameters. It has become convention to evaluate these measures relative to the nation's national income, as measured by *Gross Domestic Product* (GDP). Therefore, the following analysis considers three fiscal measures:

- Government expenditure as a percentage of GDP.
- Overall tax revenue as a percentage of GDP.
- The fiscal deficit as a percentage of GDP.

3. GOVERNMENT EXPENDITURE

To place the expenditure impact of a *Basic Income Grant* into perspective, this section provides an overview of social expenditure within the context of overall government spending. Figure 1 provides an overview for the fiscal year 2000/01. GDP for the fiscal year 2000/01 amounted to R897.9 billion, of which 27.4% was spent on public expenditure (R245.6 billion). Expenditure on social services totalled R112.4 billion, which amounts to 45.8% of public expenditure and 12.5% of national income. Of the total public expenditure, 11.1% was allocated to social security benefits and 34.7% was allocated to benefits in kind (health, education and housing). Social security benefits represent 3% of national income and benefits in kind represent 9.5% of national income.

In total, R27,285 million was spent on social security benefits, of which R19,308 million was spent on non contributory benefits and R7,977 million on national insurance. During the fiscal year 2000/01, non contributory benefits constituted 7.9% of public expenditure and 2.2% of GDP. Among non contributory benefits, the *State Old Age Pension* received the highest percentage of public expenditure (5.1%), followed by the *Disability Grant* (1.8%) and the *Child Support Grant* (0.6%).

Figure 1: Overview of South Africa's social security system, fiscal year 2000/01

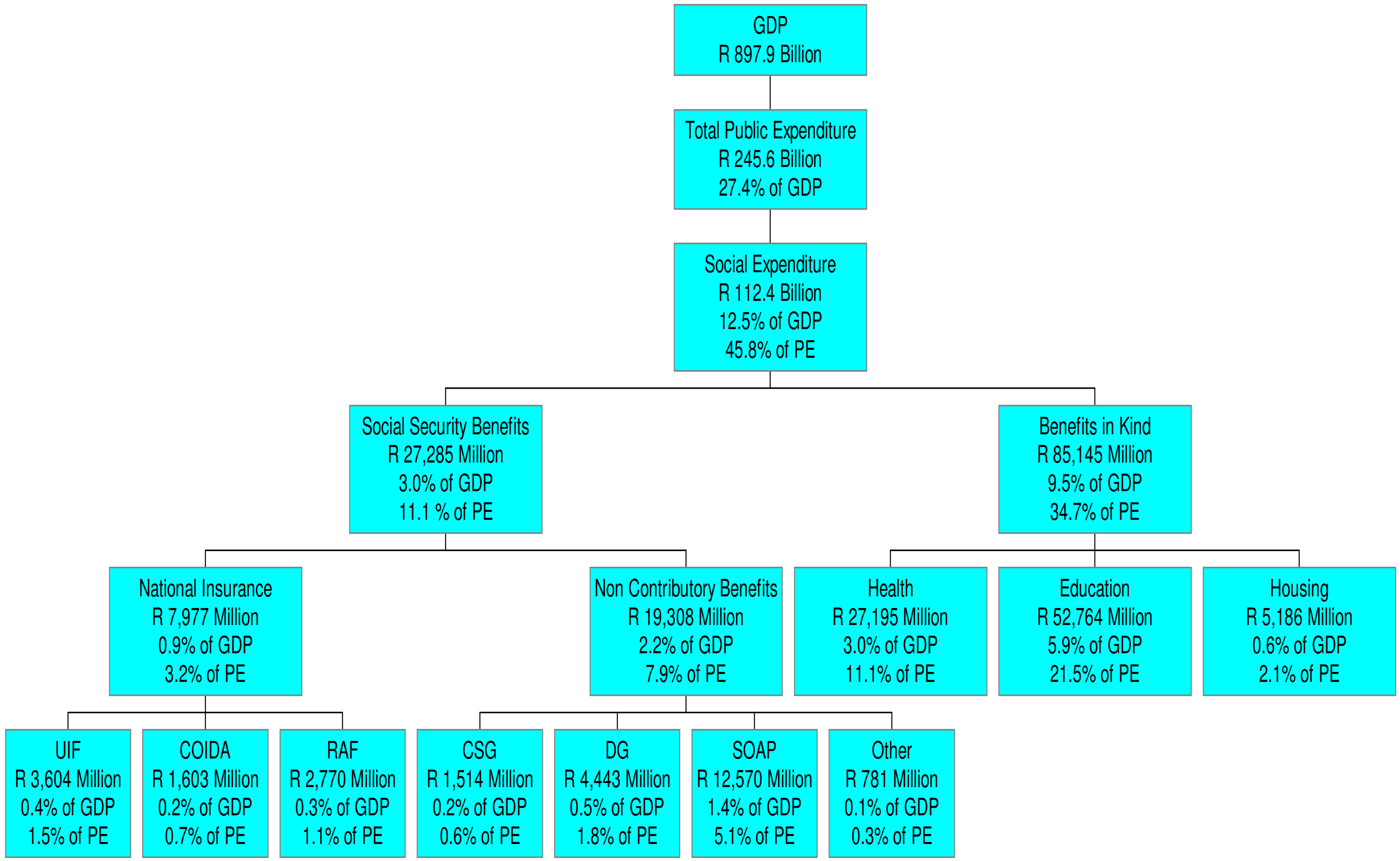
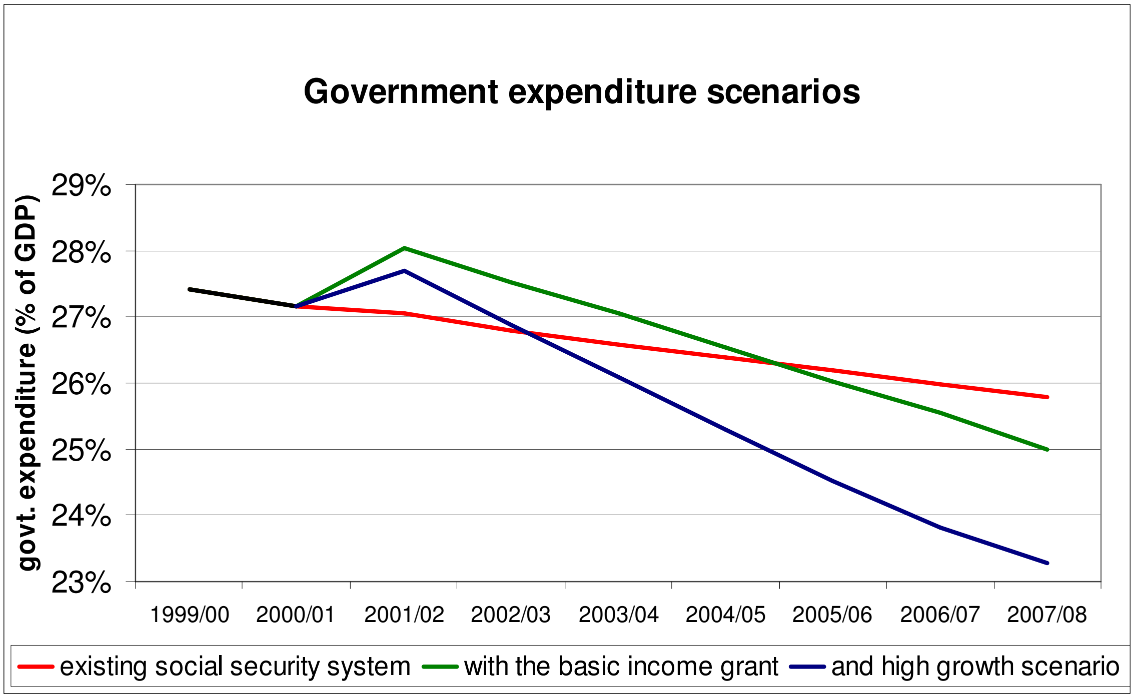


Figure 2 models the fiscal impact of a *Basic Income Grant* by analysing t projected time path of total government expenditure as a percentage of national income.

Figure 2: The Basic Income Grant and government expenditure



The government's *Medium Term Budget Policy Statement* (MTBPS) projects a steady decline in the ratio of government expenditure to national income over the next three years. Projecting the same trend until fiscal year 2007/08, and applying a gradual take-up rate of the *Basic Income Grant* and resulting growth effects, the fiscal impact can be assessed.

Under both the conservative and more aggressive growth assumptions, government expenditure relative to national income falls more rapidly than under the baseline scenario, although from a higher starting point in the first year of the *Basic Income Grant*. By 2005/06, however, under the conservative scenario, expenditure is back in line with the trend in the government's MTBPS, and falls more rapidly thereafter. Under the more aggressive assumptions, progress in reducing the fiscal impact is achieved more rapidly.

4. TAX REVENUE

Figure 3 compares South Africa's tax revenue to government receipts of OECD countries during the past decade, demonstrating that South Africa's tax structure is not unduly burdensome.[3] The average OECD country's ratio of revenue to national income is 42.3%, compared to a ratio of 24.7% for South Africa. The relevance of an OECD comparison is supported by the argument that unduly high tax rates will induce immigration out of South Africa, and the overwhelming majority of immigration from South Africa is to OECD countries. The relevance is reinforced by the comparability of South Africa's financial system--a key determinant of taxable capacity--to those in industrialised countries. The remainder of this section reviews previous research on South Africa's tax effort.

4.1 TAX STRUCTURE

Studies of the South African tax system document the extent to which lower and middle income groups bear a disproportionate share of the tax burden.[4] From 1994 to 1996, South Africa derived more than a quarter of its tax revenue from VAT, yet the poorest fifth of the population spend 61% of their consumption expenditure on goods subject to VAT, while the wealthiest fifth of the population spend only 43% of their consumption expenditure these types of goods. The *Katz Commission* report, recognising the "huge disparity of incomes and assets between the various groups in South Africa", argues for the need for greater reliance on wealth taxes.[5]

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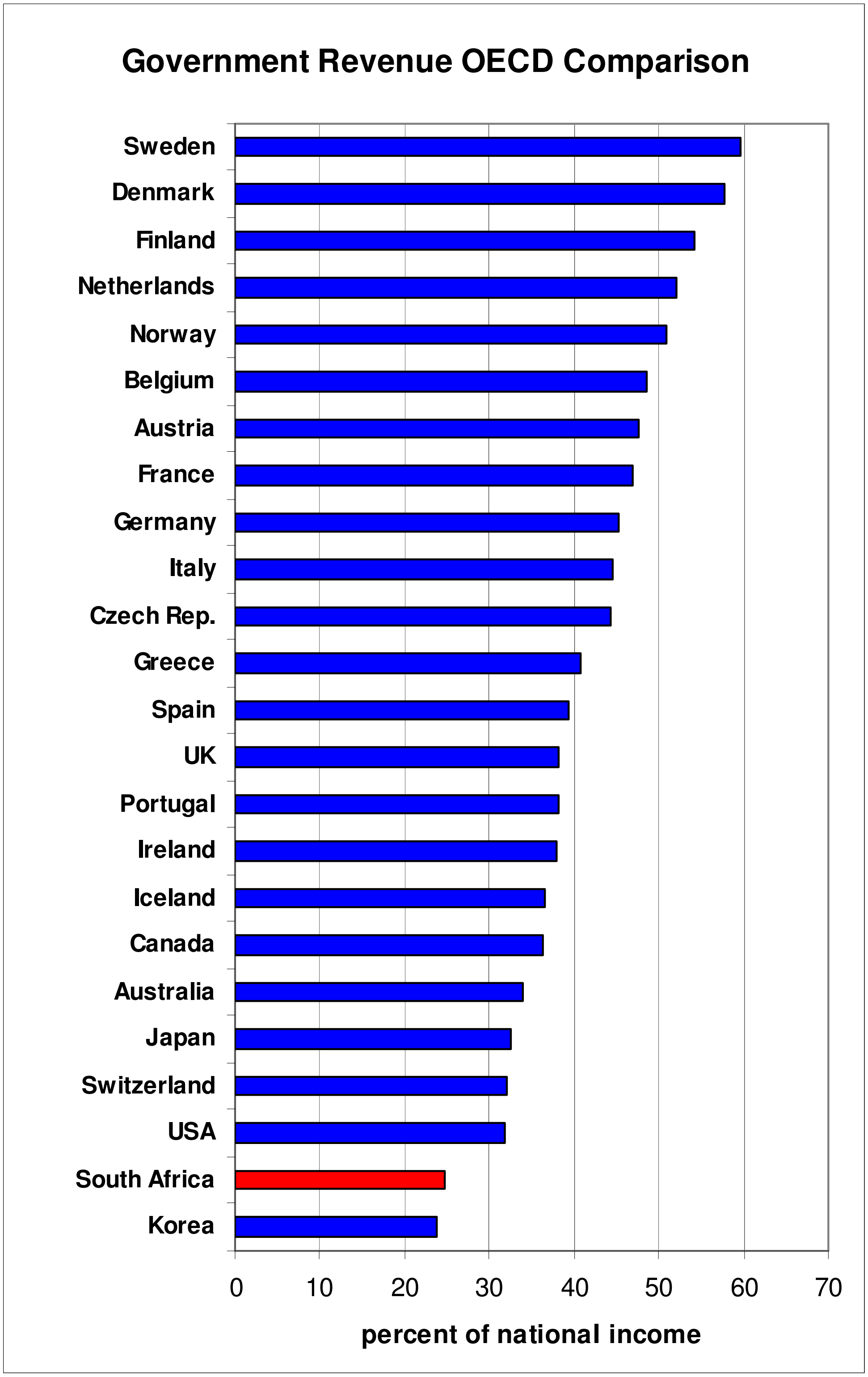
3 The comparison includes data for all countries listed in the OECD 1999 yearbook, averaging all data for the 1990s. South Africa's data covers the timeframe comparable with the OECD sample, with data drawn from the 2000 Budget Review.
4 Harber (1995).

Figure 3: Government revenue OECD comparison

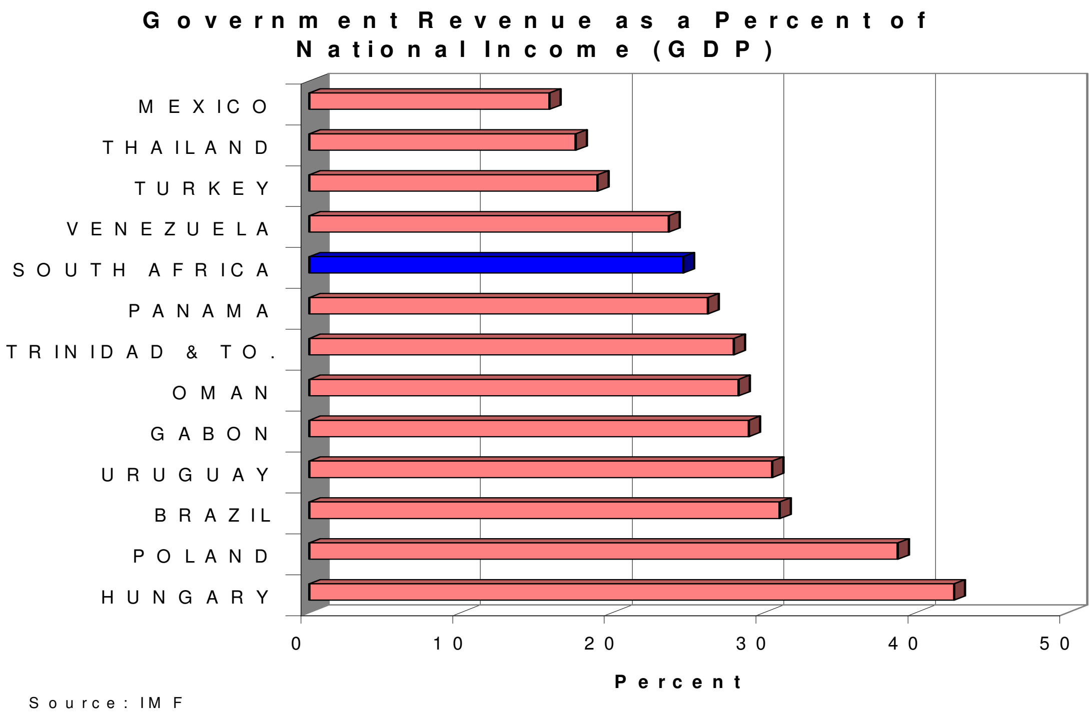


5 Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995).

4.2 GOVERNMENT REVENUE AND TAX RATIO COMPARISONS

Studies document that South Africa's government revenue (relative to national income) is significantly less than that of other countries with comparable income levels. Figure 4, from a study by the *Economic Policy Research Institute*, shows average government revenue (relative to national income) for countries with *per capita* incomes within 20% of South Africa's level. Figure 4 indicates that South Africa's government revenue (as a percentage of national income) is about four percentage points lower than the average for countries with similar income levels.

Figure 4: Comparable country government revenue comparison



A previous research paper supported a similar conclusion, comparing South Africa's tax ratio with those of countries with similar income levels. The ten countries with *per capita* incomes closest to South Africa were analysed—their average tax rate was six percentage points higher than that for South Africa.[6] Econometric studies that control for individual country characteristics have found South Africa's average tax rate to be significantly less than that which would be predicted given the country's economic profile.[7] Furthermore, tax effort analysis suggests that South Africa could mobilise up to an additional R25 billion per year without undermining international competitiveness.[8]

4.3 TOWARDS A MORE EQUITABLE TAX SYSTEM

The revenue potential from a more equitable tax system requires detailed investigation. Preliminary analysis indicates that a capital gains tax can increase total revenue by between R5 billion to R10 billion, including both direct capital gains taxes plus indirect revenue effects resulting from eliminating inefficient tax arbitrage.[9] The *Katz Commission* suggests that the revenue from improved tax compliance may generate at least R5 billion, while other estimates place the figure as high as R15 billion.[10] The *Katz Commission* notes that some countries have generated between 1% and 1.5% of total tax revenue from inheritance taxes and estate duties, which in South Africa's case is more than R2 billion.[11]

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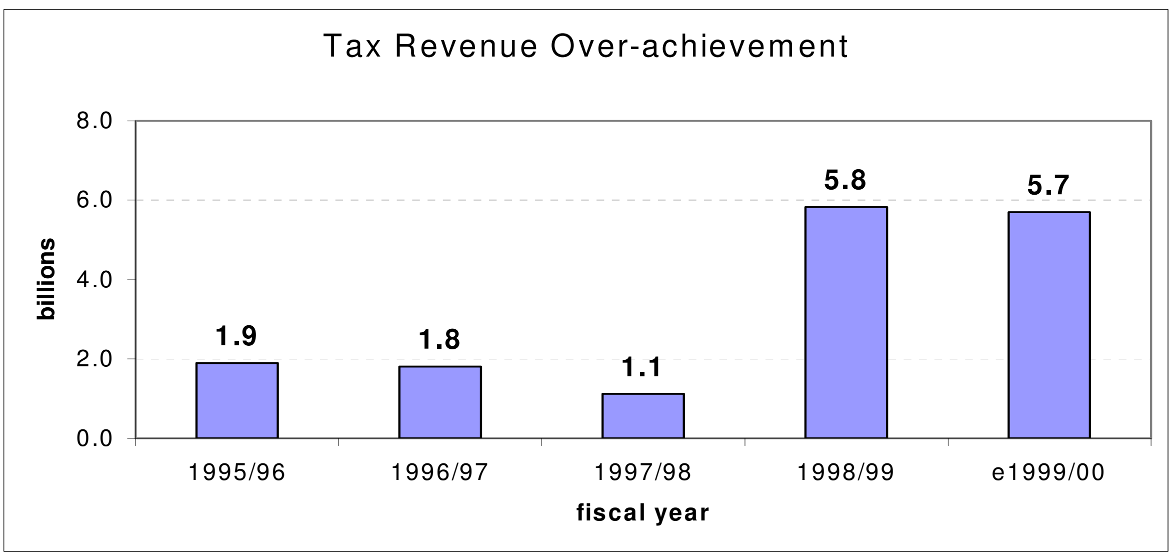
6 Samson, Mac Quene, van Niekerk, Ngqungwana (1997).
7 Harber (1995), Samson (1996), Samson, Mac Quene, van Niekerk, and Ngqungwana (1997).
8 Samson (1996), Harber (1995).
9 The absence of a capital gains tax has created incentives for wealthy individuals to create schemes that convert other forms of income into artificial capital gains. This is both economically inefficient and costly in terms of foregone tax revenue. The recent capital gains tax legislation will begin to address this problem.
10 Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1994), Harber (1995).
11 Third Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa (1995).

Historical and international comparisons of income tax yields suggest that South Africa could generate higher revenue from increased reliance on corporate taxes and a more progressive tax structure. Restructuring VAT along progressive lines, primarily by increasing the rate on luxury goods can generate additional revenue of several billion rand per year.

South Africa's relatively low level of taxation has been consistent with an over-achievement of revenue targets (see Figure 5). Improvements in tax administration and efficiency have enabled the *South African Revenue Service* (SARS) to raise tax collections more rapidly than predicted. With tax rates well below revenue-inefficient levels, increased collection efforts productively yields abundant returns. Over the past six years, South Africa has consistently over-achieved its budgeted tax revenue targets. Given this experience, the high degree of efficient capacity in the Department of Finance, the existing backlog of uncollected taxes, and South Africa's relatively low tax ratio, expectations are likely to persist that SARS will continue to over-achieve budgeted revenue targets.

Figure 5: South African tax revenue performance



5. THE FISCAL DEFICIT

The fiscal deficit is a potential source of financing for the *Basic Income Grant*. As discussed earlier, however, the taxable capacity of the country is more than sufficient to finance the cost of the transfers. Therefore, unless there is a political decision to balance the financing between taxation and borrowing, the *Basic Income Grant* will have no impact on the fiscal deficit.

6. CONCLUSION

The net cost of *Basic Income Grant* transfers would be R23.9 billion. The *Basic Income Grant* therefore represents a substantial commitment of fiscal resources. However, a well-managed programme is affordable and consistent with fiscal responsibility. South Africa's tax structure has the potential to finance the entire cost of the programme without recourse to deficit spending.

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