IRR Submission to the Treasury: On grants

Applicable categories: i) Income tax – individuals, employment, and savings and vi) Tax administration.

IRR recommendation:

- Maintain the existing grants system as-is, except for inflation-related increases.
- For reasons of fiscal stability, do not introduce a Basic Income Grant or other large-scale expansions of the grants system.
- Guide policy towards less state dependency and more self-sufficiency (based on earned income) by raising the demand for labour.
- Raise the demand for labour by promoting growth-friendly policies.

Background

The Taylor Committee of Inquiry into Comprehensive Social Security first recommended a needs-based Basic Income Grant (BIG) in 2002. Since then, South Africa has increasingly had to confront how to balance the call for comprehensive social assistance with affordability and the fiscal responsibility needed to allow the economy to grow. Even while the question of introducing a BIG remains heavily contested, social assistance has already been significantly expanded, with total payouts increasing by roughly a factor of four since 1994 in real terms on a non-racial basis.

The temporary Covid-19 Social Relief of Distress (SRD) grant drew attention to the gap in social assistance coverage for working-age individuals, with approximately 92% of its beneficiaries in 2023 falling between the ages of 20 and 59 years and therefore neither being covered by child support grants nor old-age pensions.

The purpose of this submission is to argue for the continuation of the current permanent grant system with adjustments only for inflation. We argue that increasing the SRD grant payment rate beyond inflation is not feasible, and likewise increasing grant rates more broadly, or adding a new grant beyond the SRD grant for working age, able-bodied people, is also unfeasible. We outline the practical problems and the unintended consequences of increasing grant payouts. This submission is being made under the categories of i) Income tax – individuals, employment, and savings and vi) Tax administration.

Legal nature of the problem

The Constitution secures a series of "progressive" rights, such as "access to adequate housing", "health care services, including reproductive health care", "sufficient food and water", "social security, including appropriate social assistance for those unable to support themselves and their dependants", and both "basic education" and "further education". This mandates the state to take reasonable measures to deliver on these rights over time. These rights are, however, subject to an important limitation: their fulfilment must occur "within available resources". Progress here is scarcity-indexed, meaning that the state must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of these rights. The Constitution therefore prohibits enacting policies or statutes that promise progress on paper but are fiscally unfeasible in practice.

The principle of progressive realisation also covers social security, meaning that it cannot be expanded through unsustainable measures. Adding new grants to the existing system without secure funding would undermine the fiscal integrity of the state and violate the constitutional requirement for reasonable legislative measures.

Current economic and fiscal constraints make increasing the SRD grant payment rate beyond inflation impractical. This is especially true if the fiscus continues to be burdened by Black Economic Empowerment (BEE) premiums and the second-order waste associated with it.

Detailed Factual Description

As a result of the increase in payout of child support grants and the SRD grant, government spending on this line item has increased substantially. Government spending on social protection increased from 9.3% as a proportion of total expenditure in 1994/95 to 16.6% in 2023/24. The 2024 Budget provided for R251 billion in grant payouts. The number of beneficiaries of social grants increased from 2.4 million in 1996/97 to 19.1 million in 2023/24. Half of all households benefit from social grants and 23% of households rely on social grants as their main source of income.

The dependency ratio worsened dramatically from 2001, when every 100 social grants were backed by 313 people with jobs, to 2023, when just 62 employed people stood behind every 100 social grants given. It is the direction of travel in this trend that places a question mark over the sustainability of ongoing increases in the size of the dependent population, without corresponding increases in the size of the productive population. The result is increasing pressure on a shrinking tax base and an unsustainable distribution of the tax burden. This ultimately risks overstretching the progressive nature of the tax system.

It is of concern that the current welfare system has no path to transition beneficiaries off social assistance into employment or economic independence. The Department of Social Welfare appears to be operating in relative isolation and premises its work on an unconstrained expansion of welfare, without taking into account competing spending priorities and the obligation of the Treasury to manage the nation's finances prudently and responsibly.

It is against this backdrop that we urge the government to not lose sight of the need to address underlying structural problems in the economy, like unemployment and low economic growth. These need urgently to be fixed, and simply expanding welfare payments – both in terms of the number of recipients and the amounts paid – does not help solve the underlying issues.

In fact, it might make them worse, as recent empirical research in the US indicates that payment of an unconditional grant reduces labour market participation, reduces the number of hours worked, does not improve the quality of employment, and does not result in investments in human capital.[1] While this evidence is not conclusive, it should give policy makers reason to pause.

Financial implications

A fundamental argument against large-scale expansion of the already large social grants system is that increasing grants beyond inflation, or significantly expanding the pools of recipients, will undermine the macroeconomic stability of the country. Expanding social assistance on this scale would require substantial reforms and increases in revenue streams. The following section focus on the fiscal and revenue implications of financing such an expansion.

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[1] National Bureau of Economic Research (July 2024): The Employment Effects of a Guaranteed Income: Experimental Evidence from Two U.S. States, https://www.nber.org/papers/w32719, accessed on 25 November 2024.

The three largest sources of tax revenue – personal income tax, value added tax (VAT) and corporate income tax – are already under pressure. Revenue collection growth has remained modest, with the Medium-Term Expenditure Framework (MTEF) adopting a conservative outlook. Any additional tax measures, including increasing corporate and dividends taxes and new wealth taxes, risk further reducing South Africa's appeal as a preferred jurisdiction for potential investors and businesses.

One proposed solution that has been floated in the media is to finance increased grants through a higher VAT rate on luxury goods. This option has been thoroughly evaluated and dismissed by the David Tax Committee in its second Report on VAT. The committee found that implementing a luxury VAT would be prohibitively expensive to administer, create loopholes, and provide various opportunities for corruption.

If an increase in VAT were applied across the board instead, the regressive nature of VAT would disproportionately burden poorer households. This approach would result in a circular and administratively wasteful process of effectively taxing the poor more to pay the poor more without achieving meaningful redistribution.

Alternative proposals to increase other tax rates must confront the evidence that South Africa is beyond the peak of the Laffer curve. Higher tax rates will yield diminishing returns by supressing economic activity and discouraging compliance. This is evident from the 2017 increase in the maximum personal income tax rate from 41% to 45%, applicable to individuals earning more than R1.5 million per annum.

At the time, the increase was expected to affect around 100,000 taxpayers and generate an additional R5.46 billion in revenue. However, the result was a R6.48 billion drop in total personal income tax revenue, which according to the United Nations University's World Institute for Development Economics Research (UNU-WIDER), demonstrates that the "new top tax rate [is] on the wrong side of the Laffer curve."

Increasing tax rates also holds serious implications for tax revenue distribution. Rather than forming a single, continuous pattern of revenue distribution, tax revenues cluster around middle income (R500,000 – R750,000 per annum) and high-income earners (more than R1.5 million per annum) who together account for 46.7% of the total personal income tax payable. Normally, as income rises, tax contributions should increase proportionally, but a major decrease is seen in the tax contribution made by individuals earning between R750,000 and R1.5 million. This has been the case historically with the tax burden being uneven and possibly non-progressive.

Increases in tax revenue are therefore not a reliable means to finance additional social assistance. Tax revenue growth depends on infrastructure development, employment, and economic growth. If the government prioritises social assistance over these factors, the budget risks overcompensation as a result of very limited economic growth.

If increased grant payments are not financed through higher taxes, the only remaining options are to redirect existing expenditures or resort to borrowing. However, redirecting spending is fraught with limitations. Infrastructure investment in the country is already critically underfunded, and reducing the public sector wage bill is politically untenable in the current climate.

This leaves BEE premiums in public procurement as the most viable option for potential reallocation. BEE premiums and the associated inefficiencies are estimated to waste over R100 billion per annum. Redirecting this expenditure towards value-for-money public procurement would directly benefit millions more impoverished South Africans than the nominal beneficiaries of BEE premiums who often do not experience meaningful improvements in their quality of life.

Finally, increasing grant payments through debt financing is simply unaffordable. Government is quickly approaching a 76% debt-to-GDP ratio. Adding to this debt burden will also increase interest payments, risk the country's primary surplus, crowd out important expenditure, and threaten the country's credit ratings. This will jeopardise the future payout of social assistance and the country's long-term fiscal stability.

Conclusion

Increasing grant payments beyond inflation, or significantly increasing the pool of beneficiaries, comes with serious risks. It will add to increasing dependency on state support and a shrinking tax base, depressing economic activity, causing fewer people to find jobs and forcing even more people depend on grants. As more people rely on unconditional social grants and fewer gain employment, the tax base will shrink further.

Raising maximum tax rates might also prompt high-income earners to emigrate to lower-tax countries, which would further shrink the tax base. Those who stay might work less or be creative to avoid taxes. This would negatively affect economic growth and undermine tax collection. Similarly, for businesses, higher taxes would mean lower profits and less incentive to invest, particularly for small and medium enterprises that are least equipped to handle additional tax burdens. This could lead to closures or substantial layoffs which would drive up unemployment and further inhibit economic growth. These effects would place an even greater burden on the remaining tax base.

In this submission we urge Treasury to consider that tax payers are the engine of the economy. Their continued presence, investment, and economic activity are essential for the country's financial stability. To retain them, the government must provide certainty on the future of the grants system. Raising the SRD grant beyond inflation, introducing a Basic Income Grant or other types of grant, or significantly expanding the pool of recipients, will not address the root causes of poverty and inequality. Instead, it will impose even greater burdens on South Africa's stretched tax payers, slow down economic growth, increase pressure on the fiscus, and leave unemployment, inequality, and poverty largely unchanged.

The IRR recommends maintaining the current grant system and allowing for inflation-related increases, but firmly opposes the introduction of a BIG or any large-scale expansions of the grants system. Policy must be focused on raising the demand for labour to reduce state dependency and promote self-sufficiency. This can be achieved by implementing growth-friendly policies that prioritise economic development, trade, and employment opportunities. Allowing economic growth to take precedence, in the context of prudent fiscal management, will build a strong economy that benefits all citizens.

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