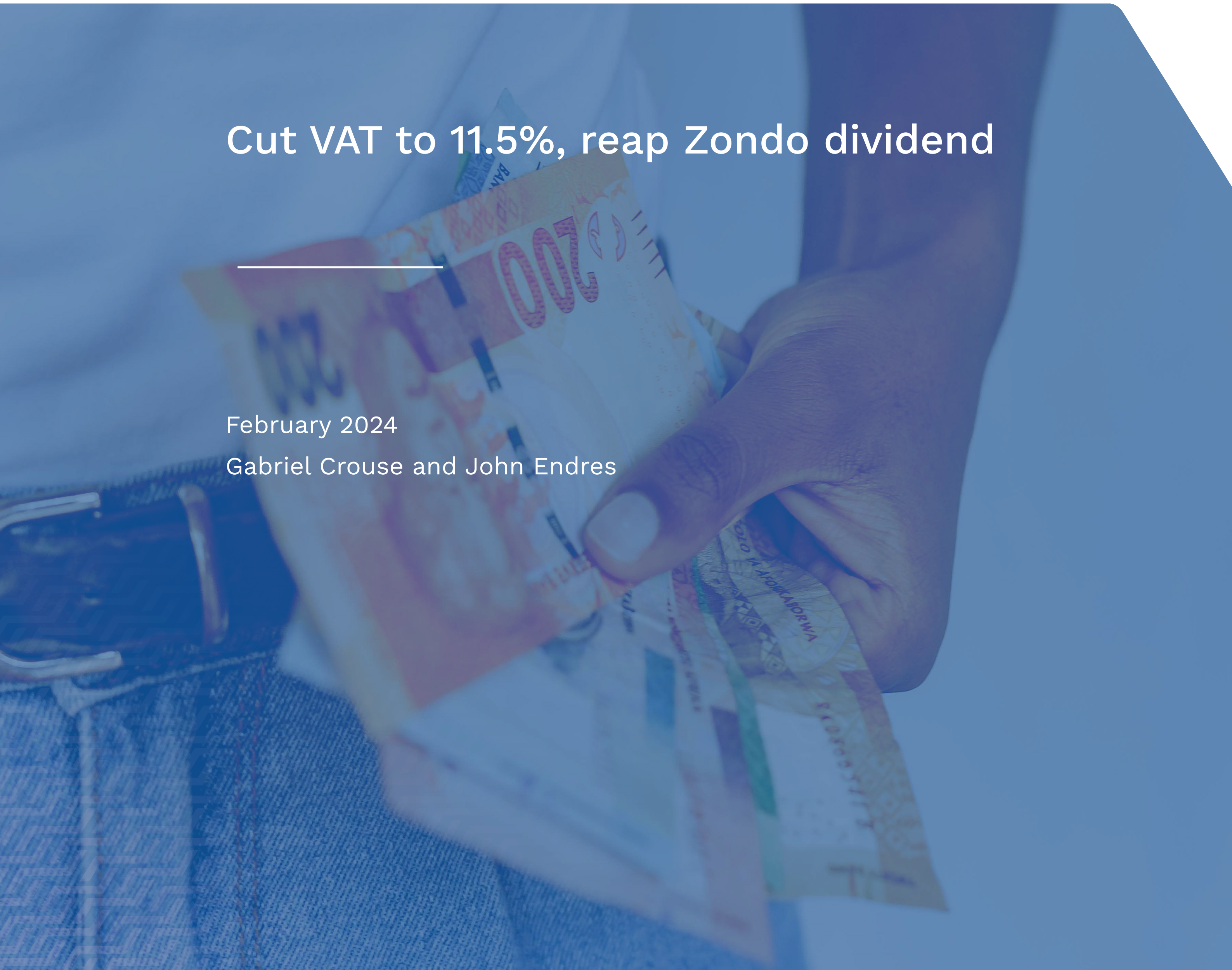
Bang for your buck,
whatever government buys

Cut VAT to 11.5%, reap Zondo dividend



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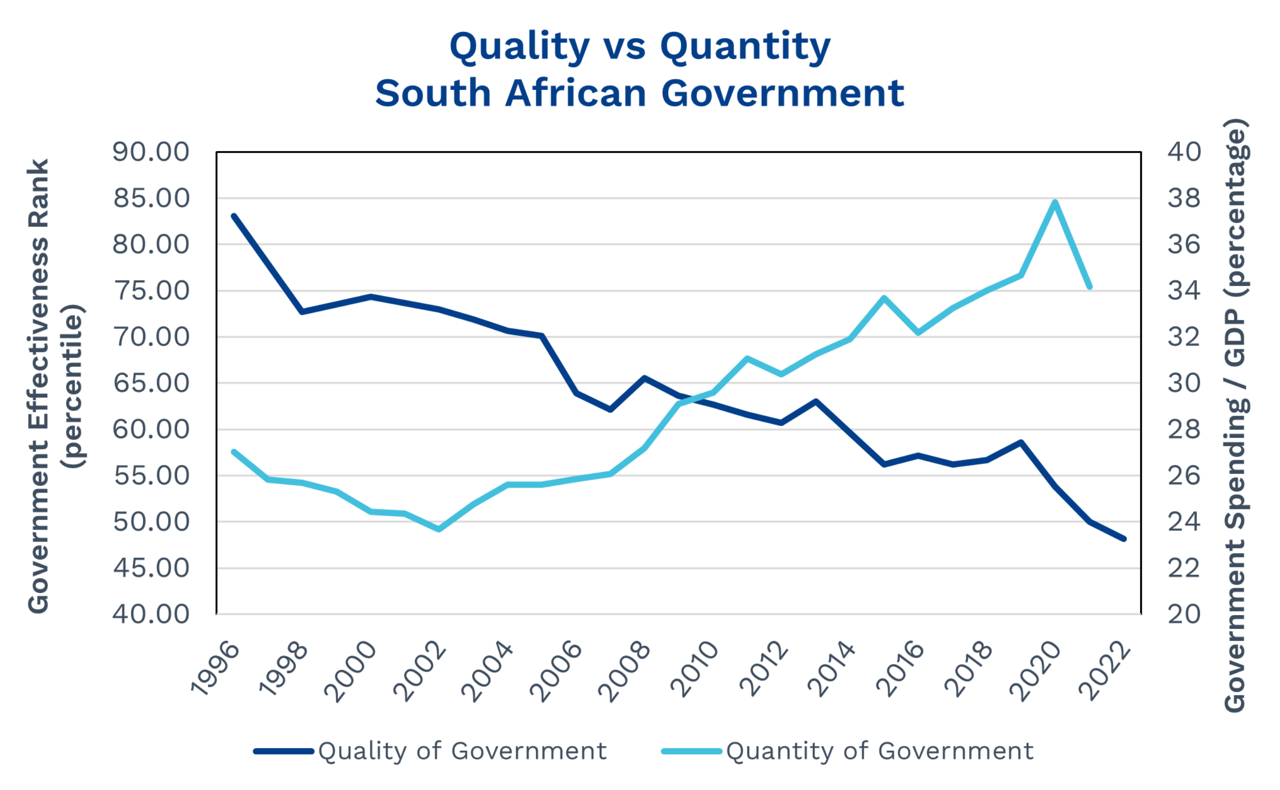
Introduction

Since 1996, South Africa's government has become more expensive but less effective. What is to be done about this?

The IRR argues that the simplest and most direct way to address this situation is to cut the VAT rate from 15% to 11.5%, while implementing the Zondo commission's recommendation to maximise value-for-money procurement in the public sector.[1]



This chart compares the quality of government in South Africa with the size of government.

The quality of government is shown by the dark blue line. The line is going down, meaning the quality of government is getting worse. This measurement of quality is based on a World Bank assessment of the government's regulatory quality, part of a set of statistics known as the Worldwide Governance Indicators. Compared to other countries in the world, South Africa has had the 12th worst drop in regulatory effectiveness rankings, and the 7th worst of major sovereign democracies.

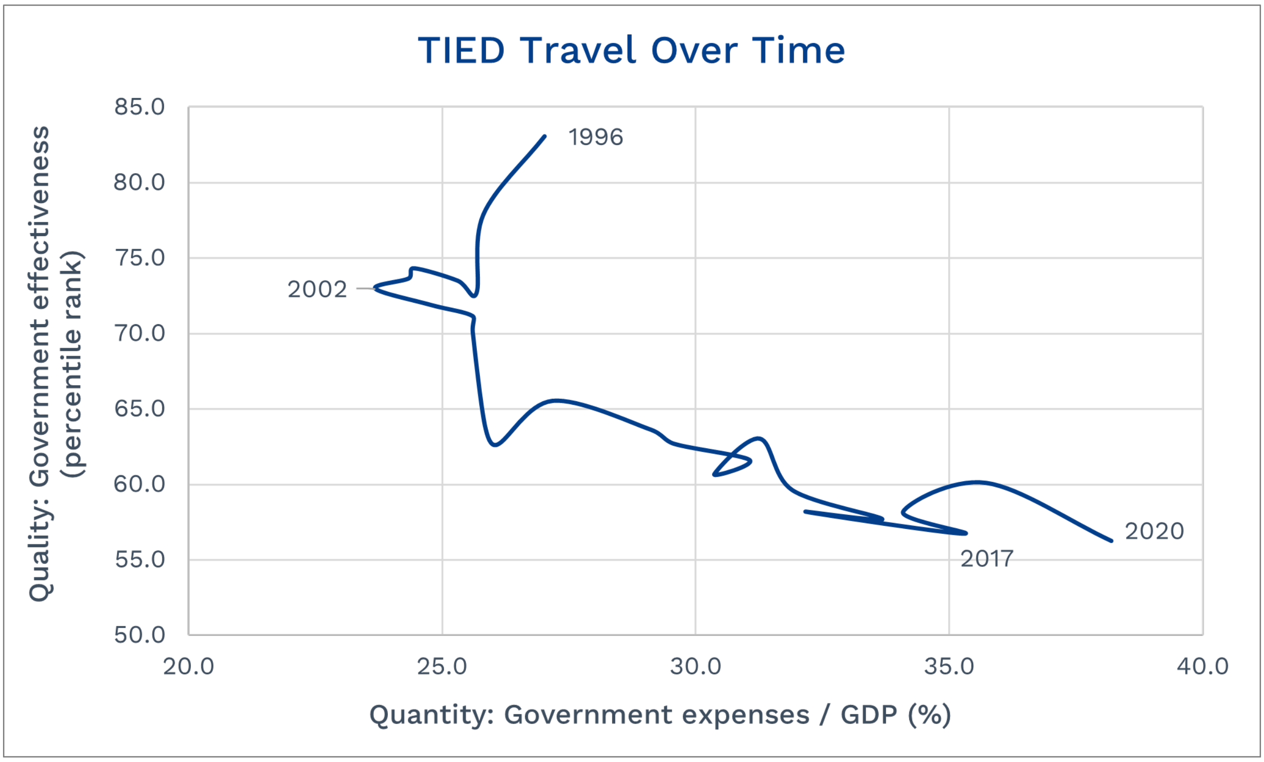
The quantity of government is shown by the light blue line. The line is going up, meaning the government is growing larger and larger. This is based on comparing the amount of money the government spends each year to the size of the entire economy. Compared to other countries, South Africa's government grew larger at the 8th fastest rate in the world between 1996 and 2022.

1 This document summarises a more extensive technical report that is available on request.

SA's government is becoming worse and larger at the same time – the worst combination.

Put the two indicators together, and you see the quality of the government worsening even as it is becoming bigger and bigger. That means South Africans are getting more and more of a bad thing. In our paper we refer to this as TIED: Tax Increase, Effectiveness Decrease. A TIED score can be calculated by combining the value that measures how much worse the government is getting with the value that measures how much larger it is getting.

South Africa has been moving in a TIED direction for decades. Between 1996 and 2019, South Africa has the world's second worst TIED score (second only to Lesotho). This means that to the second worst degree globally, South Africa's state has bloated as its effectiveness declined. The following chart shows South Africa's travel over time. South Africa has been moving to the bottom right, which equates to a higher TIED score; the best direction in which to travel from this position is towards the top left.



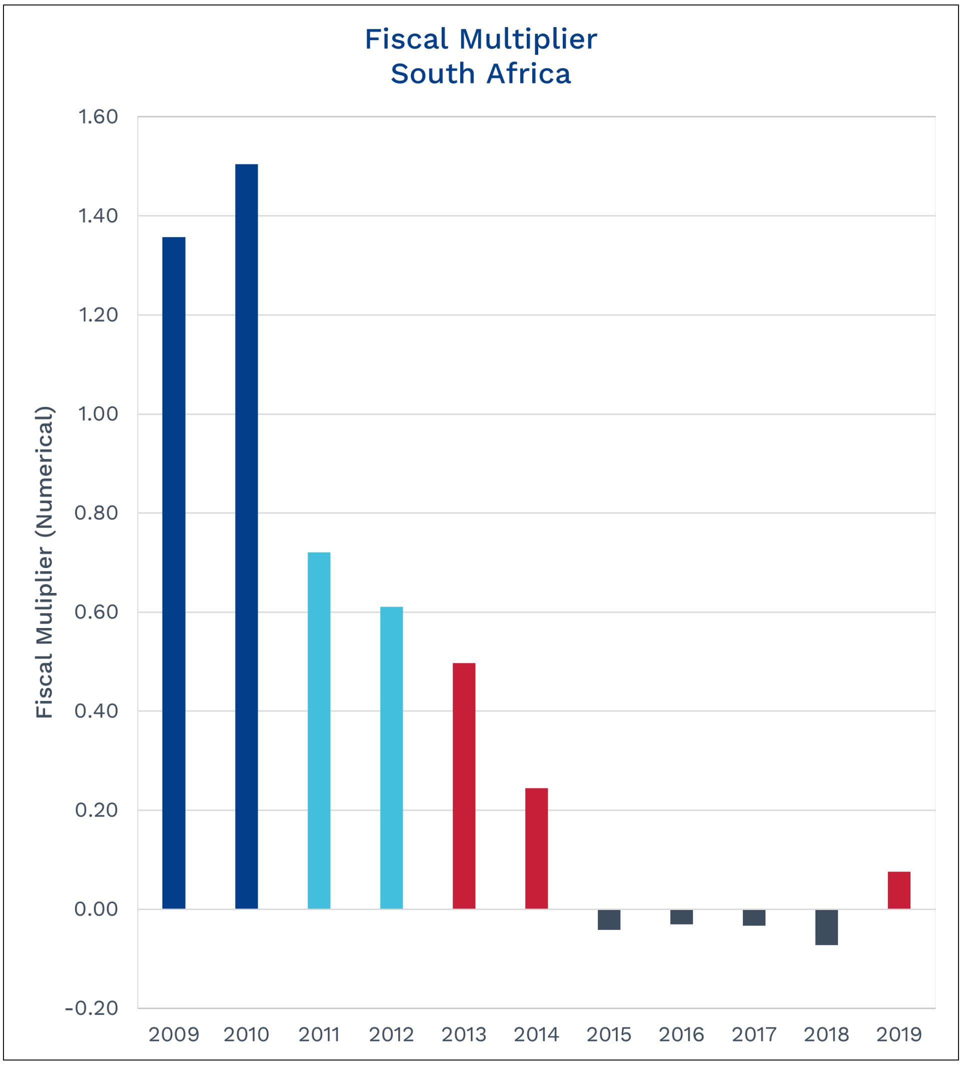
The fiscal multiplier shows that SA's government is too large.

The fiscal multiplier measures the impact of government spending. You want this number to be larger than 1. When the fiscal multiplier is larger than 1, it means that for every R1 which the government takes out of the economy through taxes and then puts back into the economy by spending it, it grows the economy by more than R1. In other words, it is adding value.

However, when the fiscal multiplier is smaller than 1, it means that spending R1 produces a GDP impact of less than R1.

Under these conditions, it might be better for the government not to take so much money out of the economy for its spending needs, because each rand it takes would potentially have a better impact if it was instead left in the pocket of ordinary consumers, to spend as they wish.

But in South Africa the fiscal multiplier is not only smaller than 1 – *it is even smaller than 0*. This means that when the state spends money, the economy shrinks. This is shocking evidence that in South Africa, resources are being badly misallocated by the state. The chart below shows how South Africa's fiscal multiplier changed between 2009 and 2019.



But why is this happening?

There are many reasons, but one of the most important was identified by now Chief Justice Raymond Zondo when he was chairing the State Capture Commission.

The state spends over R1.1 trillion per year buying goods and services. But often it spends too much money – it overpays when it could be buying things for less. This is because the of a 'problem in the legislative design', which fails to provide clarity about how the government should be making its buying decisions.

On the one hand the system requires that the government must buy on a value-for-money basis. But on the other hand, it requires that the government spend more than is necessary to incentivise businesses to score more BEE points.

These two things are, as the Zondo Report noted, sometimes contradictory. The effect has been that the state has been spending more than it needs to by adding a 'BEE premium' on top of what it needs to pay.

The Zondo Report did not say that there is anything wrong with this per se. Instead, the second-order effects on corruption control were found to be a systemic weakness. Why? Because the imperative to pay BEE premiums has not been reconciled with the imperative to maximise value for money. Both are given top priority.

That means value for money trumps BEE premiums and BEE premiums trump value for money. '[U]ndoubtedly there are other cases some of which may well be high-value tenders in which one or other of these two objectives must be preferred, and it is in such cases that the legislation fails to give guidance.' This makes procurement decisions confused, or discretionary, and difficult to account. For a sense of how bad the problem is, notice that Treasury has never budgeted for the payment of BEE premiums – despite paying BEE premiums for decades. Transparency hits a brick wall from the starting block.

As a result of all of this, Justice Zondo wrote in his report: *'Ultimately in the view of the Commission the primary national interest is best served when the government derives the maximum value-for-money in the procurement process and procurement officials should be so advised.'*

So what is the solution?

Our analysis shows that the state does a bad job of spending your money. Therefore, it should do two things: it should take less of your money in the form of taxes. And it should spend the money it does take better.

The quickest and fairest way for the government to leave more money in the pockets of ordinary consumers is to lower the VAT rate. That way all South Africans will benefit from having to pay less for the goods and services they buy, leaving them with more money to spend on the things that matter to them.

This will help stimulate the economy as more disposable income means more consumer demand, without the need to print money; it will also give some people scope to save some of their money for the future, which helps make money available for companies to invest in growth.

Lowering the VAT rate from its current level of 15% to 11.5%, as we propose, will reduce the state's annual revenue by about R100 billion. Instead, a large part of those R100 billion will be left in the pockets of ordinary people to spend as they choose.

The state will be short R100 billion, but it can easily make up for it by reaping the Zondo dividend: that means changing its procurement rules to prioritise value-for-money procurement, as Justice Zondo recommended. According to our (conservative) calculations, there are R150 billion available in state savings, ready for the taking just by clarifying the procurement rules and making sure the state gets value for money when it buys things. Saving R100 billion out of the R150 billion available should be quite achievable. This is a simple way in which the government can spend our money in better ways.

How can this be implemented?

Implementing these changes – dropping VAT to 11.5% and changing public procurement to focus on maximising value-for-money – is not hard and would be popular with voters. But it takes clarity of vision to see it and political will to do it. South Africans are encouraged to write to the president and finance minister to explain that they want to pay less tax to the state, and that they want the state to spend their tax money better by prioritising value-for-money public procurement.

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