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Economywide effects of the proposed increase in Value Added Tax and Excise Duties

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1. Background

The South African government has proposed an increase in several taxes such as the Value Added Tax (VAT) and excise duties, as part of its fiscal strategy to generate additional revenue and address public health concerns. In the 2025/26 budget, the government proposed to increase VAT by 0.5% points in each of the next two years, bringing VAT to 16% by 2026/27. In addition, excise taxes on alcoholic beverages are set to increase by 6.83% in the current fiscal year. VAT is an advanced tax system that emerged in the mid-20th century as a consumption-based tax, aimed at improving revenue collection efficiency and reducing tax evasion (Von Berg, 2020). In contrast, excise taxes are duties imposed on specific commodities, such as alcohol, and tobacco, both domestically produced and imported. Excise taxes also serve a dual purpose, that is, discouraging consumption of alcohol and tobacco while also generating government revenue.

In South Africa, VAT was introduced in 1991, replacing the previous General Sales Tax (GST) of 13% (Kwebulane & Oyekale, 2024). Initially, VAT was set at 10% but was increased in 1993 to 14% in response to economic conditions and government fiscal needs (Erero, 2021). The latest notable change occurred in 2018 when South Africa increased its VAT rate to 15%, to address budget deficits. A VAT is the second-largest contributor to tax revenue followed by personal income tax (Von Berg, 2020), it remains controversial due to its regressive nature since poorer households spend a larger proportion of their income on VAT-taxed goods unlike wealthier individuals. On the other hand, South Africa's alcohol excise framework was introduced in 2004, setting a guideline tax incidence where excise duties and VAT accounted for specific percentages of the retail price for wine, beer, and spirits. Adjustments to these guidelines over the years have seen excise duties consistently rise above inflation, sometimes exceeding the intended burden, thereby raising concerns among affected industries.

The harmful use of alcohol has been identified as a major public health risk, impeding progress toward various health-related Sustainable Development Goals (SDGs). Alcohol is responsible for 5.1% of the global burden of disease and injury, with the World Health Organization (WHO) reporting over 3.3 million alcohol-related deaths annually, accounting for 5.3% of all deaths worldwide (WHO, 2018). Recently, there has been increased attention on how excise taxes can help achieve public health goals by curbing alcohol consumption, which has significant health and social consequences. As part of the WHO Global Strategy (2022–2030), there is a renewed focus on using taxation to reduce alcohol harm as a public health priority. South Africa, a member state of the WHO, is committed to implementing the organization's guidelines and recommendations to tackle alcohol abuse within the country. Notably, despite increases in excise duties over the years, per capita consumption of alcohol by both women and men remains relatively high at a rate of 7.1 % (World Bank, 2024).

These taxes (VAT and excise duties) are particularly relevant to the agricultural and food sectors. The proposed 6.83% increase in excise duties on alcoholic beverages is expected to have ripple effects across the agricultural industry, specifically the wine and brandy industry while the 0.5% increases in VAT are also expected to have regressive effects on lower-income consumers and households. The domestic alcohol beverage industry plays an important role in terms of economic development through its contribution to the country's Gross Domestic Product (GDP), generating employment opportunities, and foreign exchange earnings. According to the Drinks Federation of South Africa (DF-SA, 2024), in 2022, the beverage industry contributed approximately 3.6% (about R226.3 billion) to the South Africa's GDP and 6.7% (R96.9 billion) in government tax revenue collection. In addition, the entire alcohol beverage industry employs approximately 500 000 people (sustains about 498 999 jobs). Specifically, In 2022, the wine industry contributed a value of R56 billion to the country's GDP with a labour force of about 270 364 employees in the entire wine value chain (of which about 85 962 are employed in farms and cellars). However, despite of the industry's importance, it is still plagued by several challenges that

are compromising its competitiveness, sustainability, and are discouraging investments within the sector. These include climate change related issues, reduction in the number of wine producers/or cellars, illicit trade, and the rising excise duties, among others.

Although the government plans to expand the basket of VAT zero-rated foodstuffs and not increase general fuel levy to mitigate the impact of this increase on households; the general proposed increase in VAT means more substantial portion of income of low- and middle-income households will go toward taxes, thus reducing their disposable income. Previous studies have shown that VAT increases can lead to slight increase in poverty and inequality. For example, the 2018 VAT increment from 14% to 15% in South Africa caused a marginal rise in poverty and inequality (SA-TIED, 2019). From a food security perspective, while South Africa is considered to be food secure at the national level, many households are food insecure, since not all households have access to adequate food. According to Statistics South Africa (Stats SA), approximately 3.7 million households faced moderate to severe food insecurity, while 1.5 million households endured severe hunger in 2023. This highlights the persistent issue of unequal access to food, particularly among low-income households and marginalized communities, where poverty, inequality, and high unemployment rates exacerbate the problem. With increasing economic pressures and rising food prices, ensuring food security remains a significant challenge for the country.

Upon approval by parliament, the proposed increase in VAT is bound to come into effect on 1 May 2025, along with the proposed adjustments to the alcohol excise taxation policy framework, which include the introduction of a three-tier progressive excise duty rate structure for wine and beer based on the level of alcohol content. The proposed increase in excise duties on alcohol (with a particular focus on wine and brandy) seeks to raise the effective excise rate by a factor of 1.4 to 1.8 times depending on the level of alcohol content. It is envisaged that the government will raise an additional R30 billion in revenue over two years through the VAT and an additional R1 billion through the proposed excise duty framework in 2025/26. Consequently, it is against this background that this advisory note aims to analyze the economywide effects of proposed tax changes in a bid to raise the additional government revenue.

2. Methodology

2.1. Analytical method

A MONASH-style single-country dynamic computable general equilibrium (CGE) model modified for South Africa called the University of Pretoria General Equilibrium Model (UPGEM) model was used in the analysis. The UPGEM model was modified for policy simulations to address research questions specific to the South African economy and the agriculture sector. The theoretical specification of a MONASH-style CGE model is documented in Dixon and Rimmer (2002) and Dixon et al. (2013) and is solved using the GEMPACK solution software discussed in Horridge et al. (2013). It has five primary agricultural industries (i.e., field crops, fruits and vegetables, fishing, forestry, and livestock) and ten agro-food processing sectors (i.e., meat, fisheries, fruits and vegetables, oil fats, dairy, grains, confectionary, beverage, tobacco, and other food industries). The rest of the economic sectors in the database are aggregated across various other industry groups. The database is updated with latest available Supply-Use Tables and macroeconomic and sectoral data and projections.

2.2. Simulation scenarios

1. Increase in VAT to raise an additional R30 billion in VAT revenue over two years

2. Increase in excise duties on alcohol products to raise an additional R1 billion in excise revenue

Note that due to the differences in additional tax revenue targeted in each simulation, results are not directly comparable.

2.3. Stylized facts on alcoholic beverages industry

From the most recent supply-use tables for 2019 published by Stats SA, it is shown that the alcoholic beverages industry as a whole produces more than R200 billion worth of products, and contributes around R60 billion in indirect taxes (mainly VAT, excise and import duties). Output from the agriculture industry is a key input to the alcoholic beverages industry. For example, more than R7 billion worth of viticultural products produced locally each year are linked to the wine industry. Excise duties on alcohol and tobacco products alone are more than R40 billion annually, of which the wine and brandy industry is estimated to contribute about R7 billion.

3. Results and discussion

3.1. Scenario 1 VAT simulation results

Should the targeted R30 billion share of the budget shortfall be recovered entirely through a general increase in VAT, the predicted effects are negative across virtually all economic variables, with the exception of Consumer Price Index (CPI) in the first two years. Results suggests that in the first two years the proposed VAT increase will have inflationary effects 0.04% and 0.03% in years 2025 and 2026, respectively. However, from the year 2027, the CPI will slowly decline moving towards baseline due to the slightly depressing effect of higher taxes and lower disposable incomes that reduces demand-side pressure.

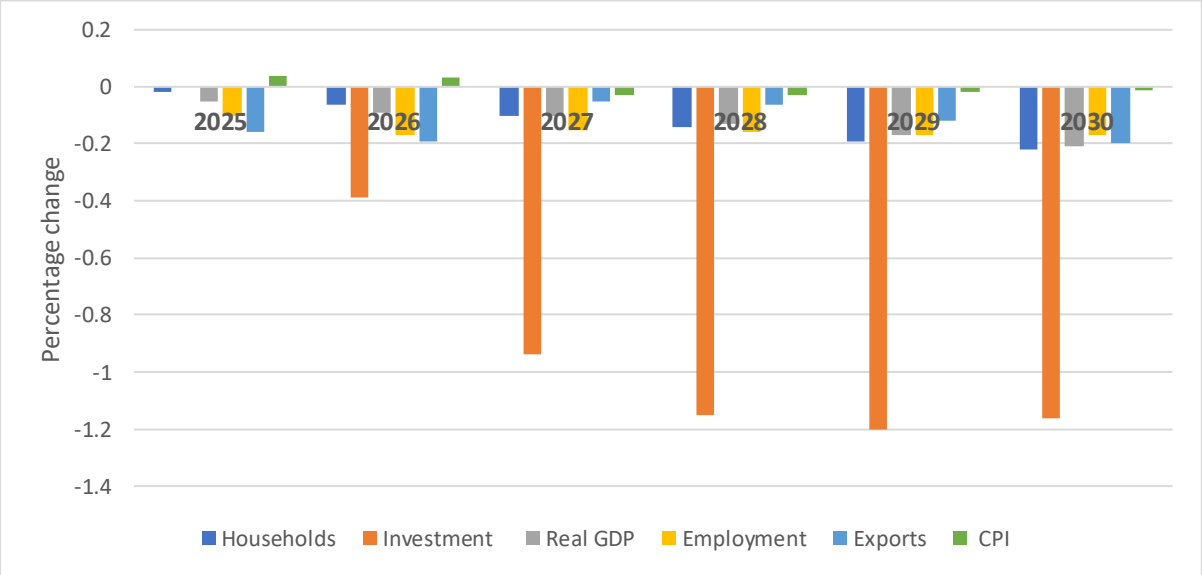

Figure 1: Scenario 1 VAT: Macroeconomic effects (in percentage change - %Δ)

Results also suggest that GDP will be negatively impacted in the medium term, while the debt-to-GDP ratio does not fall as much as may be anticipated. It is therefore key that (at least some of) the additional VAT revenue be spent in a manner that contributes to enhancing long-term productivity and economic growth. In detail, real GDP is bound to fall by 0.21% relative to the baseline in the medium term. Furthermore, household consumption is estimated to fall by 0.22% slightly above baseline (the direct inflationary effects of the VAT increase are partly offset through lower demand caused by the VAT increase).

Despite the targeted R30 billion increase in VAT collection, other forms of tax revenue collection fall due to lower disposable income and second round effects on industries lowering Personal Income Tax and Corporate Income Tax collections. Taking into account these general equilibrium effects, an increase in the VAT rate to increase government revenue by R30 billion is foreseen to increase a net tax collection of only approximately R20 billion. Industries most exposed to VAT (expressed as a higher VAT share in overall purchasers price) and higher income expenditure elasticities are bound to be hardest hit, and these include vehicles, electronics, other household luxury consumables, real estate transactions subject to VAT, and the retail sector.

From the primary agriculture sector perspective, all the subsectors will be negatively impacted as shown in Figure 2. The simulation results show that output or sales for the forestry subsector will fall by 0.4%, followed by livestock (0.26%), field crops (0.24%), and horticulture (0.23%), respectively.

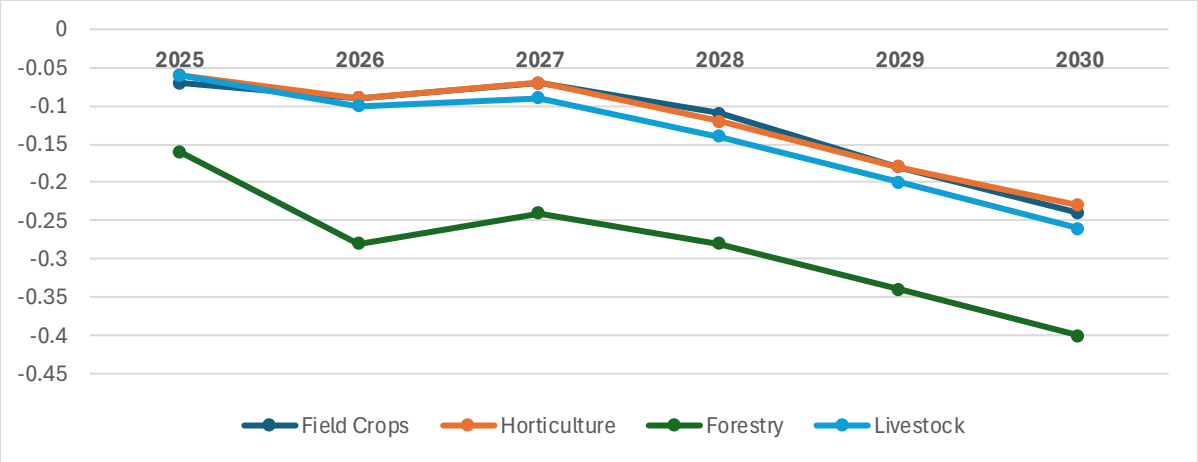

Figure 2: Scenario 1 VAT: Impact on primary agriculture (%Δ)

Whereas all food manufacturing industries will be negatively impacted as shown in Figure 3, it is eminent that the fish processing will experience the most drastic effect. Sales in the fisheries industry will fall by 0.41% in the medium term, followed by grains (0.34%), fruits and vegetables (0.33%), meat (0.29%), other food industries (0.15%), and beverages (0.14%), respectively.

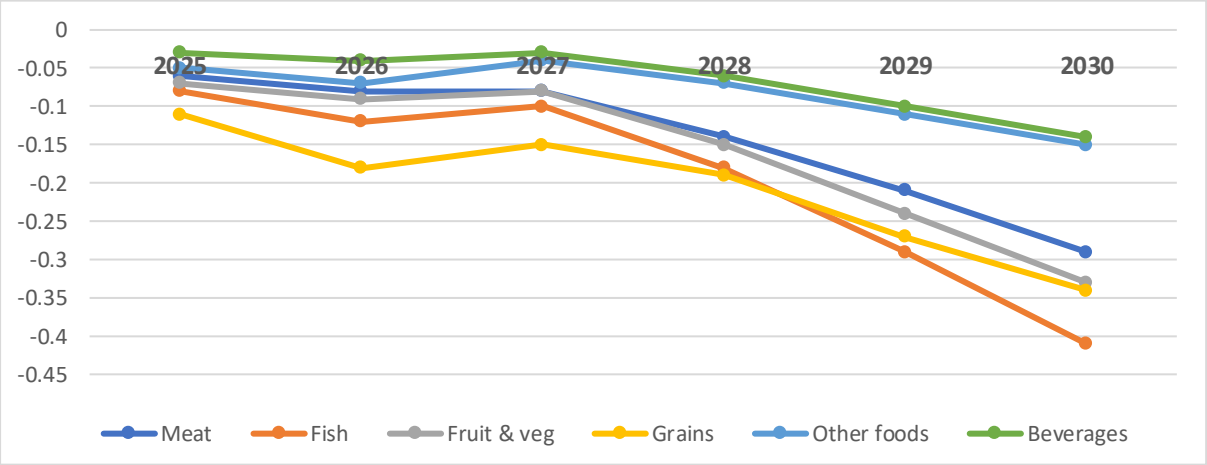

Figure 3: Scenario 1 VAT: Impact on food manufacturing (%Δ)

3.2. Scenario 2 Excise tax simulation results

The economy-wide effects of an increase in excise duties on alcoholic beverages to raise approximately R1 billion in additional tax revenue are relatively minor at a macro level, but include some important

industry-level results. Real GDP falls by only 0.01% relative to the baseline in the medium term. Household consumption falls in line with GDP and inflation ticks up slightly above baseline. The direct gain in excise duty revenue is partly offset through losses in other taxes due to lower economic activity and disposable income.

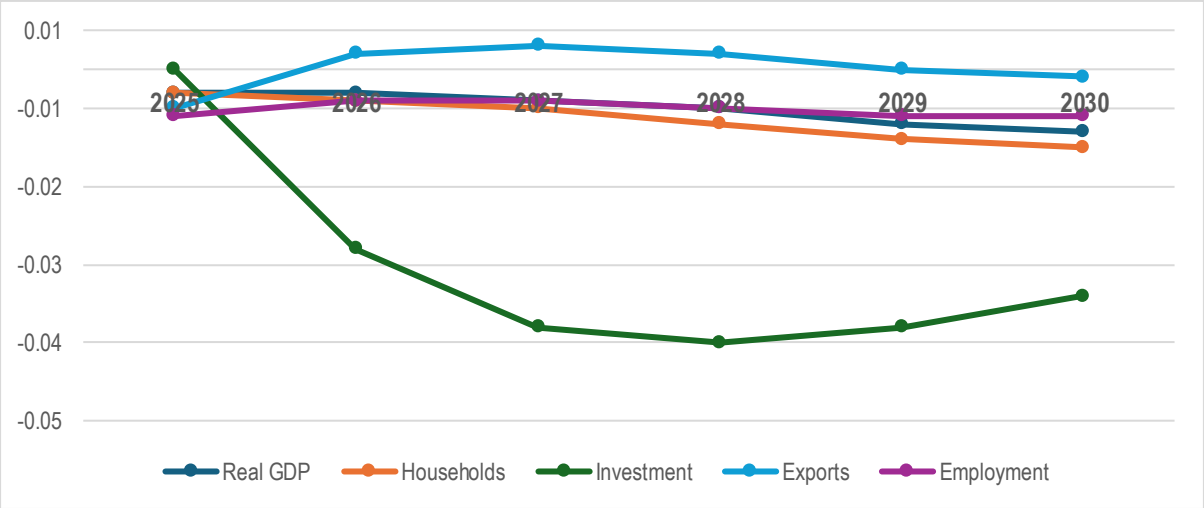

Figure 2: Scenario 2 Excise tax: Macroeconomic impacts (%Δ)

Our simulation suggests that for every R1 billion increase in excise duties collected due to higher tax rates, other tax revenue collected may fall by around R0.25 billion. At an industry level, output or sales in the beverage industry as a whole fall by over 0.3% as a result of the excise duty increase, but with these impacts will be concentrated in the alcoholic beverages industry. Sales of specific subsectors such as wine and brandy are expected to be about 1.5% lower. Note that this is an average number for the industry – the impact on specific firms will fluctuate around this number based on their individual exposures and price elasticities.

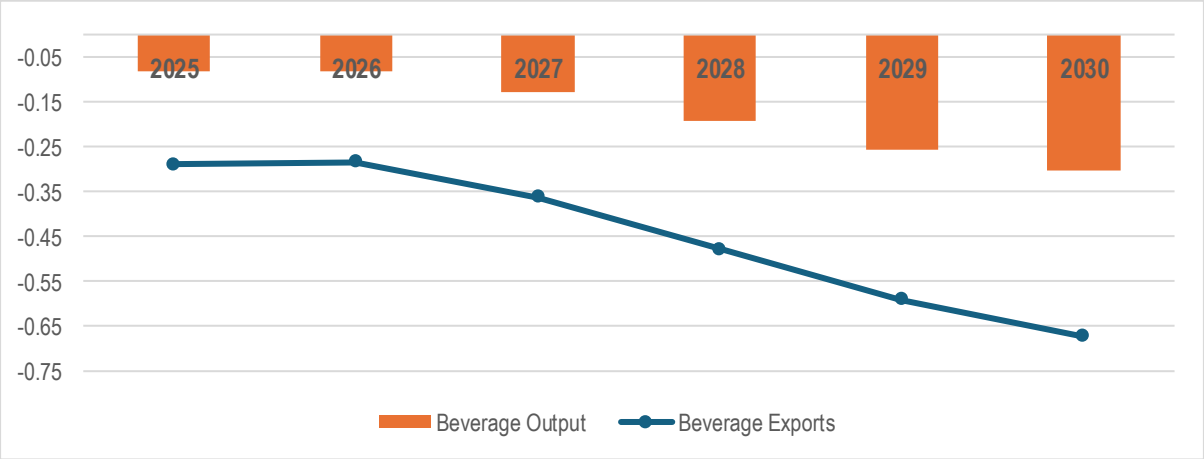

Figure 2: Scenario 2 Excise tax: Impacts on the beverage industry (%Δ)

Over R10 billion in wages can directly be attributed to the alcoholic beverages industry, which suggests around R150 million in wage earnings could be at risk relative to the baseline excluding additional indirect value chain losses in the agriculture and retail sectors.

4. Conclusion and policy considerations

In conclusion, while tax increases serve as a critical tool for revenue generation and promoting healthy lifestyle, their broader economic implications should be carefully managed through complementary

policies to ensure balanced and inclusive economic growth for local industries as well as ensuring household welfare. The analysis of the proposed increase in VAT and excise tax indicates that while these tax measures will generate additional government revenue, they will also have adverse effects on economic growth, household consumption, and productivity among key agricultural industries.

Specifically, the consecutive 0.5% VAT increases, aimed at raising R30 billion, is expected to negatively impact real GDP by 0.21% and household consumption by 0.22%, among other sectors, including food manufacturing and primary agriculture. Given its regressive nature, VAT increase will disproportionately affect low- and middle-income households, further exacerbating poverty and inequality. Additionally, due to reduced disposable income and second-round effects, the net increase in tax revenue for government is estimated to be R20 billion only as opposed to the targeted R30 billion. On the other hand, the increase in excise duties on alcoholic beverages to generate R1 billion will have relatively minor macroeconomic effects but will significantly have a negative impact on the beverage industry, particularly the wine and brandy subsectors, leading to an estimated 1.5% decline in sales. This, in turn, could place up to R150 million in wage earnings at risk within the industry, along with potential indirect losses in the agricultural and retail sectors.

To minimise the likely regressive impact of the VAT increase, the government's idea of expanding the list of zero-rated food items is recommended in order to soften the impact especially against low-income households. Moreover, given the expected decline in wine and brandy sales due to the increase in excise tax, the government should explore policy measures to support the competitiveness of the domestic beverages industry particularly, such as trade promotion strategies and incentives for value-added production. Lastly, given the potential impact of VAT on food affordability, strengthening food security policies, particularly for vulnerable households, should be prioritized to prevent an increase in hunger and malnutrition.

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