Briefing Paper
The CIT Gap in SA

HOW CAN WE CLOSE THE R79 BN CIT TAX GAP

Background and Motivation

Corporate income tax (CIT) is South Africa's third-largest revenue source, contributing roughly 17% of total tax revenue and about 4.3% of GDP. SARS estimates the CIT tax gap to be R79 billion per annum. Improving CIT collection is therefore central to the government's ability to finance public services and reduce reliance on external financing. Yet until now, South Africa has lacked systematic, firm-level evidence on where CIT non-compliance is concentrated and how it varies across different types of businesses.

This study provides the first bottom-up estimate of the corporate tax gap for South Africa, drawing on the full universe of CIT returns submitted to the South African Revenue Service (SARS) between 2016 and 2020, linked to every specialised CIT taxpayer audit conducted over the same period. **The tax gap is the difference between what firms actually reported and what they should have paid in the absence of any misreporting. The measure captures detectable non-compliance: evasion that SARS's audit processes can uncover.**

The overall estimated tax gap across the five-year period is **13.5% of potential corporate tax revenue**.

13 cents of every Rand
of CIT owed to the state goes uncollected due to underreporting.

More than 20%
of the total gap comes from the construction sector alone

> **Improving CIT collection is central to the government's ability to finance public services and reduce reliance on external financing.**

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Key Findings at a Glance

- Prior evidence points to large corporate tax revenue losses from multinational tax planning. Drawing on corporate tax returns and audit data, we show that illegal underreporting rates among multinationals tend to be low. This suggests that their tax advantage predominantly arises through legal or legally grey channels. **Increased enforcement of MNEs for illegal evasion, without complementary legal reform, will thus not meaningfully reduce their overall tax advantage.**
- Firms claiming special economic zone (SEZ) tax benefits show markedly higher evasion rates than other firms of similar size, pointing to a **hidden enforcement cost of SEZ incentive programmes.**
- **Construction is the sector with the highest evasion rates** across all firm sizes and accounts for over 20% of the estimated aggregate tax gap.
- High evasion rates among small firms may call for measures that go beyond enforcement alone. **Simplifying compliance requirements, providing clearer guidance on obligations, and making it easier for small businesses** to report accurately can reduce inadvertent non-compliance alongside deliberate evasion.

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The Size Divide: Small Firms Evade More in Relative Terms but less in absolute terms

The most striking structural finding is the sharp difference in relative evasion rates across firm sizes. Small firms (those with gross income below R20 million and total assets under R10 million) have an average tax gap of 25%, meaning that **a quarter of what they should have paid was not reported to SARS**. Medium and large firms, by contrast, have an average gap of around 2%.

This does not mean that large firms are not a revenue concern. Because large firms pay far more tax in absolute terms, even a small relative gap translates into a meaningful Rand amount. On average, **large firms still underreport more in absolute terms.**

Two mechanisms likely explain this. First, large firms face greater audit scrutiny: SARS directs the majority of its in-depth audit capacity towards larger businesses. When the probability of being caught is higher, the incentive to evade illegally is lower. Second, **large firms and multinationals have access to legal tax planning strategies that smaller firms do not, which reduces their incentive to resort to illegal misreporting.**

> **The findings suggest that legal / legally grey tax avoidance and illegal tax evasion are substitutes.**

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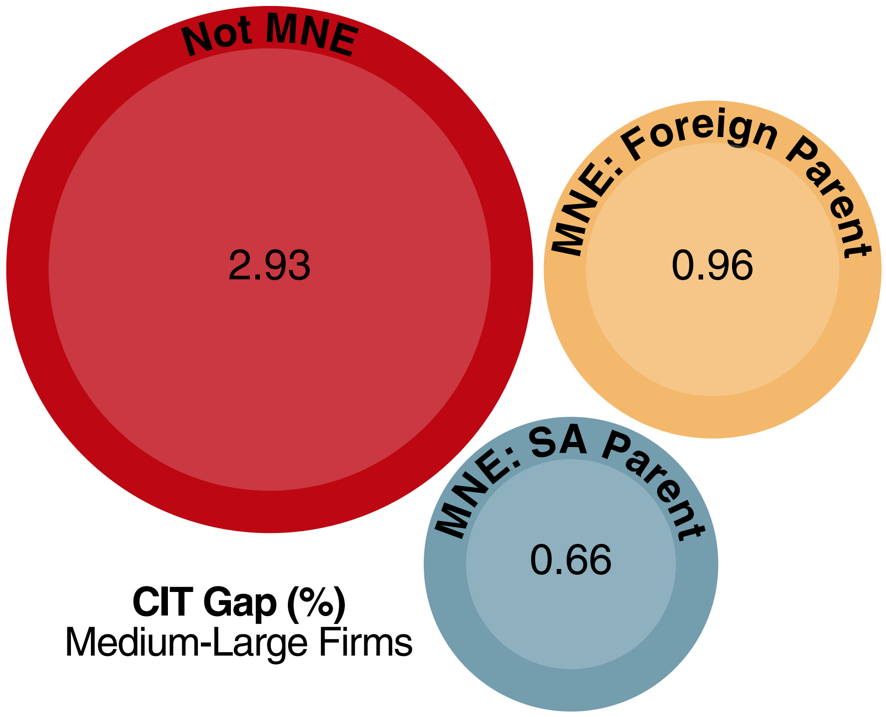
Multinationals and the Substitution Between Illegal and Illicit

A recurring concern in international tax policy is that multinational enterprises (MNEs) use their cross-border structures to reduce their tax bills, for example, by shifting profits to lower-tax jurisdictions. This planning often relates to legal grey areas. **It is estimated that many fiscally constrained governments lose large amounts of revenue due to these practices.**

The tax gap we estimate reflects illegal evasion that is detectable by SARS. Illicit financial flows and aggressive tax planning by MNEs are likely to be poorly captured in this gap.

Our findings show that among medium and large firms, the tax gap for MNEs with a South African parent is 0.66%, and for MNEs with a foreign parent, it is 0.96%. The comparable figure for national firms of the same size is 2.93%. SARS thus finds substantially lower misreporting rates among multinational firms than among their national counterparts, even after accounting for firm size.

The most plausible interpretation is that **legal / semi-legal tax avoidance and illegal tax evasion are substitutes.** Multinational firms have access to a range of mechanisms to reduce their effective tax burden:



profit shifting to affiliates in lower-tax countries, using tax treaties, and claiming a wider array of deductions and incentives.

Domestic firms have fewer of these options available. **When legal avoidance routes are limited, firms appear more likely to cross into illegal territory.**

This finding has important implications for tax policy. **If governments wish to reduce the total tax advantage that MNEs enjoy, the tools required are legislative and treaty-based, not primarily enforcement-oriented**.
Tightening audits of MNEs for illegal tax evasion would not address the bulk of the problem, because the bulk of their tax advantage operates within the current law.

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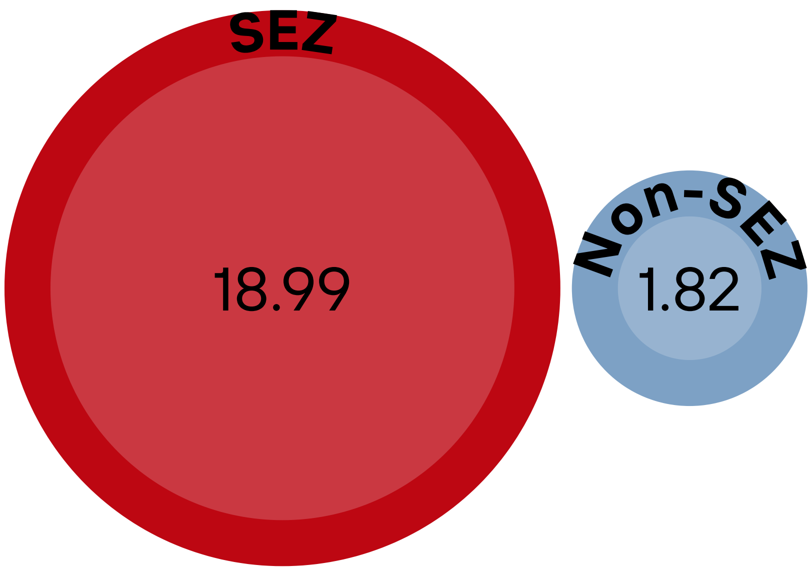

Tax Gap by SEZ Status (%)
Medium-large firms

Special Economic Zones: A Hidden Cost of Tax Incentives

South Africa's special economic zones offer qualifying firms a reduced corporate tax rate of 15%, compared to the standard 27%, along with other benefits. SEZs are intended to attract investment and economic activity, particularly from international investors. The study, however, finds that **firms operating under SEZ tax provisions show significantly higher tax gap** estimates than comparable-sized firms.

Among medium and large firms, the tax gap for SEZ-qualifying firms is estimated at 19%, compared to 1.8% for non-SEZ firms in the same size category. Among small firms, the gap is 52% for SEZ firms, compared to 25% for others.

This finding highlights a hidden administrative cost of tax incentive programmes. **When a preferential tax rate exists, it creates an incentive for non-qualifying firms to seek illegitimate access to it,** which in turn requires enforcement resources to police and correct.

This cost should be weighed against the investment benefits that SEZ programmes are designed to generate when policymakers are evaluating the design or generosity of such regimes.

In addition, SEZs in South Africa are perceived as relatively ineffective at achieving their goals. Makgetla found little growth in manufacturing value added and formal employment in SEZs.[1]

[1] Neva Makgetla, Learning from Experience: Special Economic Zones in Southern Africa (Helsinki: UNU-WIDER, 2021)

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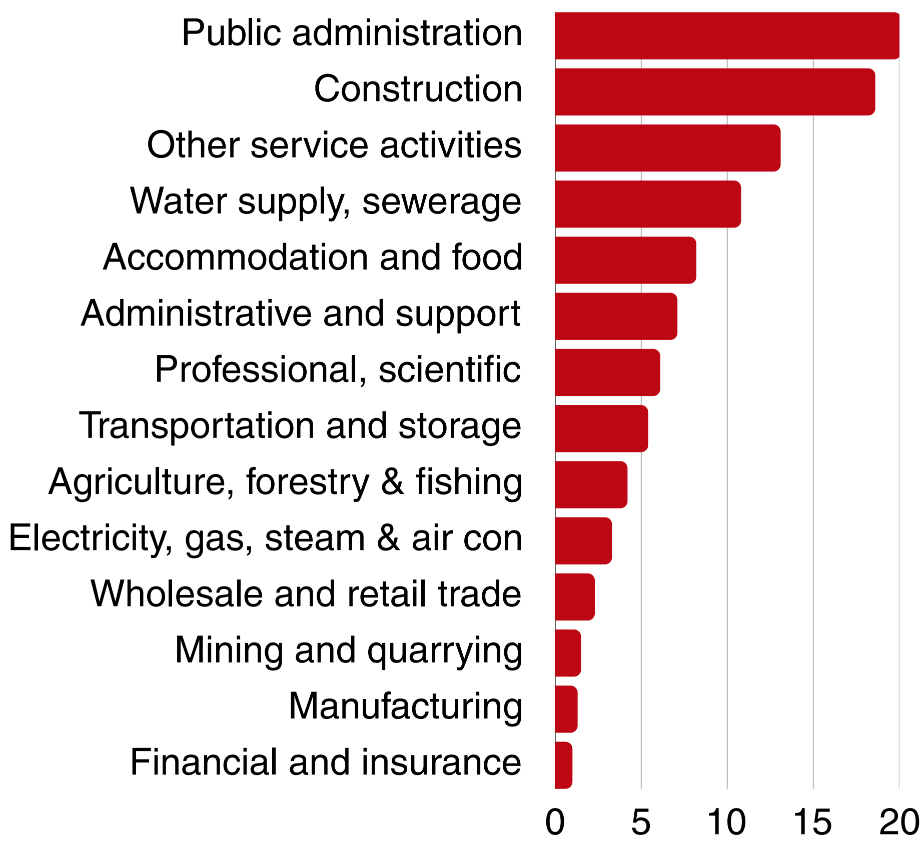
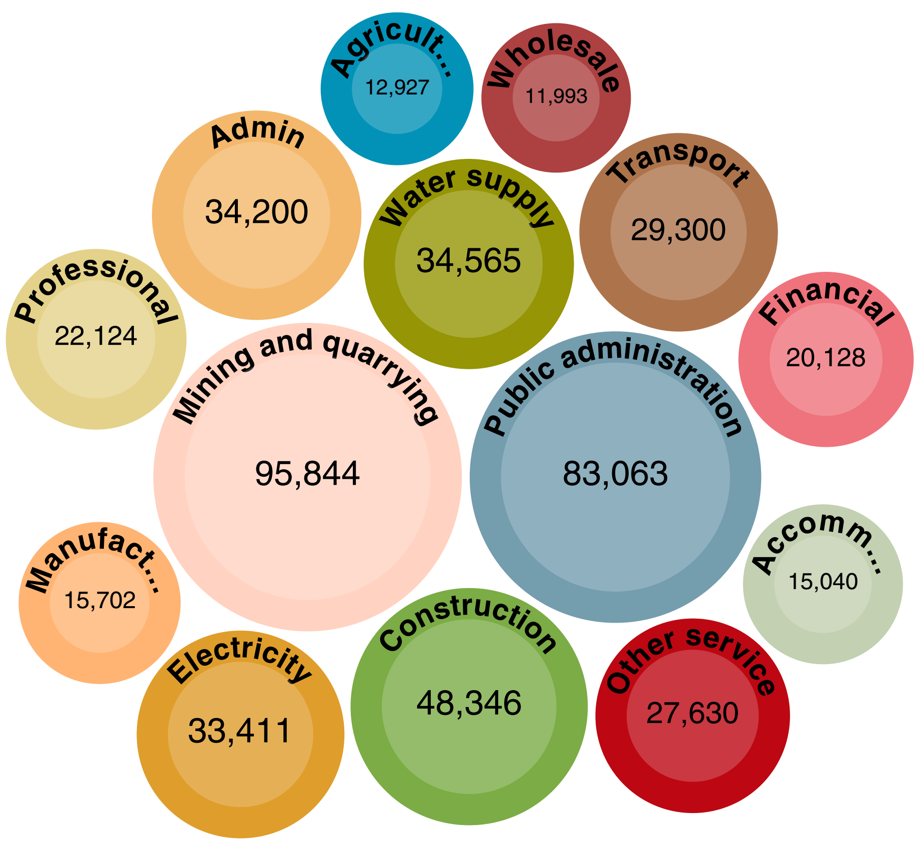
Sectoral Patterns: Construction Stands Out

Evasion rates vary substantially across sectors. **The construction industry has the highest estimated tax gap of any major sector, 18.6% across all firm sizes, and accounts for over 20% of the estimated aggregate corporate tax gap.** Within construction, all three sub-sectors (building construction, civil engineering, and specialised construction activities) show similarly elevated gaps.



Tax Gap by Industry (%)
All firms



Average Audit Adjustment by Industry (R)

The mining industry illustrates an important distinction between relative and absolute evasion. **The sector's relative tax gap is below 2%, yet because mining firms are very large, the average Rand recovery per audited mining firm is among the highest of any industry.** Both dimensions matter when allocating audit resources: relative gaps identify where the compliance problem is most severe proportionally, while absolute amounts identify where the payoff per audit is greatest.

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Policy Implications

Audit targeting

The findings support **differentiated audit strategies by firm type and sector.** Construction, accommodation, agriculture, mining, and the broader services sector warrant sustained enforcement attention given their persistently high relative gaps.

Small firm compliance

The high evasion rates among small firms call for **measures that go beyond enforcement alone**. Simplifying compliance requirements, providing clearer guidance on obligations, and making it easier for small businesses to report accurately can reduce inadvertent non-compliance alongside deliberate evasion.

Reconsidering the design of tax incentive programmes

The elevated evasion rates among SEZ-qualifying firms point to the extra costs of preferential tax regimes. Policymakers should **factor these enforcement costs into cost-benefit assessments of incentive programmes**.

> **Enforcement, simplifying compliance *and* legal reform are all needed to close the CIT tax gap.**

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Addressing MNE tax advantages through law, not enforcement

The relatively low underreporting rates among multinationals confirm that their tax advantage predominantly arises through legal or legally grey channels. Addressing this requires policy and legislative reform.

This may include:

- reinstating a **withholding tax on cross-border service fees**,
- **renegotiating problematic tax treaties** with reference to the UN Model Double Tax Convention,
- establishing a **domestic list of tax haven jurisdictions** and disallowing deductions for expenses arising from transactions with haven-based entities,
- **excluding haven-based firms** from eligibility for the participation exemption.
- expansion of the **interagency coordination to cover commercial illicit financial flows**
- active engagement in the **UN Framework Convention** on International Tax Cooperation to push for a **reformed transfer pricing system.**

> **Increased enforcement of MNEs for illegal evasion, without complementary legal reform, will not meaningfully reduce their overall tax advantage.**

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About This Study

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The study uses the full population of corporate income tax returns in South Africa (2016–2020) and the universe of major SARS audits, accessed through the National Treasury Secure Data Facility.

A machine learning model (Random Forest) is used to extrapolate audit-based evasion rates to the broader population of firms.

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