FINAL REPORT ON

MACRO ANALYSIS OF THE TAX SYSTEM AND INCLUSIVE GROWTH IN SOUTH AFRICA

FOR THE MINISTER OF FINANCE

Intended use of this document:

The Davis Tax Committee is advisory in nature and makes recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes.

As with all tax policy proposals, these proposals will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.

THE DAVIS TAX COMMITTEE

April 2016

Dear Minister

We, as the Members of the Davis Tax Committee, have the honour and privilege to provide you with this report which has been:

Prepared by:

Dr Nara Monkam — 09/03/2015

Professor Ingrid Woolard — 18/12/2014

Ms Tania Ajam — 18.12.2014

Reviewed and supported by:

Judge Dennis Davis (Chairperson) — 18/12/2014

Professor Annet Oguttu — 18/12/2014

Professor Matthew Lester — 18/12/2014

Professor Nirupa Padia — 18/12/2014

Mr Vuyo Jack — 18/12/2014

We were ably assisted by the following ex-officio Members:

Cecil Morden (National Treasury)

Kosie Louw (SARS)

And the Secretariat for the Davis Tax Committee

MACRO ANALYSIS OF THE TAX SYSTEM AND INCLUSIVE GROWTH IN SOUTH AFRICA:

AN ANALYTICAL FRAMEWORK FOR THE DAVIS TAX COMMITTEE

APRIL 2016

TABLE OF CONTENTS

LIST OF ACRONYMS AND ABBREVIATIONS

BEPS	Base Erosion/Profit shifting
CGT	Capital Gains Tax
CIT	Corporate income tax
CIPC	Companies and Intellectual Property Commission
DTC	Davis Tax Committee
FDI	Foreign direct investment
ETR	Effective tax rate
NDP	National Development Plan
NHI	National Health Insurance
METR	Marginal effective tax rate
MPRDA	Mineral and Petroleum Resources Development Act
MNE	Multi-national Enterprise
MTEF	Medium Term Expenditure Framework
PAYE	Pay As You Earn
PBO	Public Benefit Organisation
PIT	Personal Income Tax
SACU	South African Customs Union
SARS	South African Revenue Services
SDL	Skills Development Levy
SSC	Social security contribution
STC	Secondary Tax on Companies
TAA	Tax Administration Act
UDZ	Urban Development Zone
VAT	Value Added Tax

1 INTRODUCTION

The purpose of this discussion document is to:

1. Propose a broad conceptual framework for analysing the role of the tax system in supporting inclusive growth, employment, development, equity and fiscal sustainability in South Africa
2. Articulate a set of over-arching principles to guide an assessment of the current tax system status quo and proposed reforms
3. Provide an initial macro-level situational analysis of the tax system, furnishing insight into domestic and international trends, past and present, which have shaped the tax system and its impact on inclusive growth, employment, development, equity and fiscal sustainability
4. Identify further research required by the Davis Tax Committee (DTC) in discharging its mandate.

The intention of this report is not to generate recommendations, but rather to inform subsequent DTC research, which will result in specific recommendations on the range of tax policy issues which falls within its mandate, as outlined in Annexure 1.

In articulating an over-arching conceptual framework for the DTC, the main point of departure is that the South African tax system needs to maximise inclusive growth, subject to revenue adequacy and Government's intertemporal budget constraint. There is no universally recognised theoretical framework or conclusive empirical literature on how to craft a system that will not only grow the South African economy but also allow the dividends of this increased prosperity to be enjoyed by all South Africans. Evolving a future tax system to rise to this challenge must perforce be a learning exercise of trial-and-error, fraught with gaps in knowledge and uncertainty on the workings of the transmission mechanism and likely behavioural responses. The unacceptably high levels of poverty, unemployment and inequality make it imperative that this is a terrain into which South African tax policy must venture.

This discussion document relies predominantly on secondary research, drawing together existing knowledge and identifying possible gaps. The objective of this paper is not to provide an exhaustive and authoritative analysis, which would be premature, even if it were possible. Instead, it hopes to present a point of departure for developing a common understanding of the problem statement within the DTC at a macro level, to assist in prioritising the Committee's future work programme and to identify additional technical support as well as the specialist research input required to address empirical knowledge gaps and support evidence-based recommendations.

Section 2 below, outlines the importance of an overarching analytical framework for the DTC while Section 3 locates the tax system within the South African political system's conceptualisation of the role of the state. Section 4 contextualises the tax system within the economic role of the state in promoting economic growth, employment and development within the broader fiscal and economic policy. Section 5 articulates a few key principles derived from public finance theory for evaluating the current tax system and any future reform proposals. Sections 6, 7 and 8 provide a high level overview of the performance of the tax system in a democratic South Africa post-1994, with a focus on the most important tax handles. Sections 9 and 10

review the available empirical research on the fiscal incidence as well as the economic and social impact of the tax system while provincial and local government tax issues are discussed in Section 11. Sections 12 and 13 cover international reform experiences to promote inclusive growth and other important global trends which would impact the South African tax system in the medium and long term. Relative to the principles for designing a good tax system as explored in Section 5, Section 14 assesses the current South African system. Section 15 identifies current tax research gaps whereas Section 16 concludes by proposing a way forward for the DTC to generate evidence-based recommendations on tax policy and administration as per its mandate.

2 RATIONALE FOR AN OVERARCHING ANALYTICAL FRAMEWORK

Shortly after the transition to democracy in June 1994, the Katz Commission (more formally known as *the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa*) was appointed and produced nine interim reports on various dimensions of the tax system until 1999, but no final report. This Commission was, however, enormously influential in precipitating a large number of tax reforms aimed at broadening the tax base as well as improving neutrality and fairness.

At that time, the macro-organisation of the state was being fundamentally reconfigured in line with the 1996 Constitution. This entailed, firstly, the centralisation of tax policy and administration, including absorbing the tax administrations of the so-called independent homelands of (the then) Transkei, Bophuthatswana, Venda, and Ciskei; secondly, the loss of skills post-transition as tax officials, who were predominantly white, took voluntary severance packages or resigned and, thirdly, the creation of a single autonomous South African Revenue Service from the two branches of the then Department of Finance, Inland Revenue and Customs and Excise, with better audit, investigation, tax evader prosecution and debt recovery capability. Concomitant with revenue centralisation, a significant proportion of public expenditures was decentralised to the nine newly created provincial governments and to municipalities, through a complex revenue-sharing system required by the Constitution.

The discriminatory apartheid tax legislation had to be reviewed too in order to eliminate gender and racial discrimination and ensure compliance with other constitutional provisions on the right to privacy and administrative justice. The separate taxation of married persons introduced in the 1980s had begun to phase out gender discrimination, but it was essential to ensure that the tax system was fully aligned with the progressive ethos of the constitution. Furthermore, there were pressures for the tax system to support macro-stabilisation in the wake of the unforeseen costs of transition to the new democratic order and the legacy of the debt burden inherited from the Apartheid regime. Simultaneously, the tax system was required to respond to the country's reintegration into the volatile global economy, the presence of South African corporations overseas and the relaxation of exchange controls.

These factors triggered a fundamental re-design of the tax system and a plethora of tax reforms. These included: the granting of tax amnesties; introduction of tax relief for low- and middle-income taxpayers; a reduction in the number of income tax brackets; reform of fringe benefit taxation; reform of the taxation of Trusts; reduction

of the company tax rates and the Secondary Tax on Companies; tax incentives for a limited period in the form of a Tax Holiday Scheme and accelerated depreciation allowances; incorporation of transfer pricing and thin capitalisation provisions in the Income Tax Act; introduction of the Tax on Retirement Funds; a limited form of group taxation through the corporate rules regime, a significant reduction in ad valorem excise rates; the conclusion of several double tax treaties with foreign jurisdictions as well as a move from source to residence based taxation and, in 2000, the introduction of a Capital Gains Tax (CGT).

The Katz Commission had faced an ongoing tension between balancing the need to respond to the pressing issues of the day in fundamentally overhauling the tax system (given the transition pressures outlined above) and the need to engage with a long term, comprehensive and systematic framework for this system in South Africa. Despite the enormous contribution made by the Katz Commission under circumstances of great institutional change and upheaval, a number of criticisms were levelled about the absence of an over-arching analytical framework within which to locate its numerous recommendations on individual tax handles.

> The "incremental" approach to tax reform which the Commission calls for is acceptable in principle, but the link between the specific proposals and the bigger picture is not always clear. There is a need to avoid the "incremental" approach becoming "piecemeal", leaving uncertainties as to where the process is, where it is going and when it might get there… It appears that through the absence of the necessary "big plan" there seems to be an inability comprehensively to consider possible consequences and to balance and integrate different facets of thinking emerging from the Commission's investigatory work (JSCOF, 2000:3).

Furthermore, international commentators have contended that a major shortcoming of the Katz Commission was the lack of a solid empirical basis and quantitative analysis to support its arguments or estimate the anticipated impact of proposed changes to the tax system (Aaron & Slemrod, 1999). Any contemporary review of the tax system would have to be substantially more evidence based, given the two decades of experience in designing and administering tax policy since South Africa's transition to a constitutional democracy.

This juncture provides an opportune moment for another review, now that there is increased institutional maturity and stability, the returns from the first wave of reforms seem to be diminishing and fundamental re-alignments in the global economy have engendered new pressures on the South African tax system. Furthermore, Government objectives and the context of tax policy and administration have markedly altered. The prolonged aftermath of the 2008 global financial crisis, which has mutated into sovereign debt crises in the Eurozone, magnified by domestic shocks such as on-going labour conflict, suggest muted medium term growth prospects. Global tax problems, such as base erosion/profit shifting, require more coordinated responses and greater pressure to foster global convergence and governance structures. The diminishing domestic fiscal space and growing debt create pressures for fiscal consolidation in ways which least compromise the country's growth potential. Inclusive growth and employment are the top political priorities while the ambitious objectives of South Africa's first National Development Plan (NDP) will create further spending pressures over the medium to long term.

The foremost contemporary policy challenge to which South Africa has to respond is the failure of the South African economy to provide sufficient employment opportunities to work-seekers, particularly unskilled workers and the youth. Economic growth has not always increased labour absorption commensurately, with the result that formal job creation has consistently fallen far short of policy aims.

Pervasive and persistent structural unemployment has exacerbated poverty and inequality, despite substantial increases in social grant spending and other forms of social spending (education, health and the like). An effective response to unemployment requires a cohesive national policy framework, such as labour market reform, increasing basic education and health service quality, fostering skills development and so forth. Tax reform can only be one supporting element. Overburdening the tax system with a plethora of other public policy objectives is likely to be highly counter-productive. In this Framework Document, the DTC has therefore applied its mind specifically to what impact the tax system could have in fostering inclusive economic growth as its prime policy goal beyond revenue adequacy. The Framework Document explores this, both at a macroeconomic level (as outlined above) but also at the micro-economic level with regard to the choices of individual citizens in relation to labour supply, savings and consumption, and the choices of individual companies (both domestic and international) in relation to investment and employment.

3 THE ROLE OF THE STATE, BROADER FISCAL POLICY AND THE TAX SYSTEM

The role of the tax system cannot be divorced from broader fiscal and macro-economic policy or from more general conceptualisation of the role of the state itself within a particular political system. Increases in the size of government and the complexity of its functions have, over time, led to far reaching consequences for the tax system. Far from merely being a mechanical, technical exercise in economic analysis, tax policy is inherently political and ideologically contested, moulded by the dynamic interplay among economic and political institutions, interest groups and political values and culture (e.g. the degree of tolerance of inequality or the perceived legitimacy of government),. Different views of the role of the state vis-à-vis markets range from minimalist (mostly associated with free-market or even libertarian views) to interventionist (more associated with social democratic systems and “command” economies), from the “welfare state” to the contemporary South African discourse as an aspirant “democratic developmental state”, as articulated in the New Growth Path and the NDP.

Each of these perspectives has radically different implications for the fiscal system broadly and tax systems in particular. It is not surprising, therefore, that attitudes towards the tax system vary markedly. Some perspectives view taxation as a coercive, extractive exercise of predatory state power, essentially to maintain the status quo favouring powerful interest groups. Other perspectives regard taxation as an important mechanism for redistribution, social solidarity and justice as well as nation building in a manner which helps to transform not only the economy, but broader society too. One extreme of the spectrum regards all forms of taxation as market distortions which policy and administration should minimise while the other extreme perceives tax policy not simply as a means to correct market failure (through internalising negative and positive externalities) but also to stimulate and

direct growth for particular purposes through incentives and other supply side measures. Tax systems are often under huge pressure to compensate for other economic and social policy distortions which are deemed politically intractable, such as in international trade, the labour market and so forth. Paradoxically, the more efficient the tax system is perceived to be, the more these pressures to proliferate the objectives of this system intensify, diluting its focus and often introducing further distortions.

Different political systems and political values in relation to tax equity also influence the relative weight accorded to the "benefit" principle vis-à-vis the "ability to pay" principle in tax design. The benefit principle suggests that taxes should be based on the willingness of taxpayers to pay for the benefits received from public goods (as revealed through political collective choice mechanisms, such as voting). According to this principle, taxes may be regarded as analogous to the market "price" of a public good, which the user pays. The ability-to-pay principle, though, regards tax paid as a sacrifice for which there is no direct public service *quid pro quo* and which focuses on determining what an equitable burden per taxpayer would be, relative to their wealth.

In a democratic system, taxation is a critical part of the social contract between the state and its citizens. A broader tax base could foster Government accountability to citizens and, if fairly levied and properly administered, create incentives for greater responsiveness to citizens' needs and preferences, since Government depends on them for revenue, rather than other sources (e.g. non-tax revenues from oil, gas and mineral wealth sales or foreign aid). Tax legitimacy and perceptions of fairness in the distribution of the tax burden are crucial to the willingness of citizens to pay taxes, but cannot be divorced from broader Government legitimacy which is also influenced by other factors such as honest and clean governance, the efficiency and equity within which Government spending is utilised to deliver services, the degree of corruption and so forth. Despite enforcement measures, most modern tax systems depend to a large extent on voluntary compliance; thus it is vital to foster favourable taxpayer perceptions. Equally important in shaping such perceptions is their experience at the interface with tax administration which might range from courteous, professional and timely to arbitrary assessments as well as experiences of bribery and corruption.

For these reasons, not only is the substance of proposed tax reforms crucial in a democracy, but so too is the reform process of political management in relation to the business sector and the public (which have to bear the tax burden), as well to the political decision-makers who approve them and the officials who administer them. To this end, participation in, and transparency of, the tax policy development process is important.

4 THE TAX SYSTEM AND INCLUSIVE GROWTH, EMPLOYMENT, DEVELOPMENT, EQUITY AND FISCAL SUSTAINABILITY IN SOUTH AFRICA

Increasing globalisation, along with its challenges to economic competitiveness, and increased mobility of productive resources, such as skilled labour and capital and the growth of the digital economy, call for greater international coordination of tax reform efforts (as discussed in Section 12). It is, however, also essential that further tax

reform efforts are conditioned by the specific context faced by South Africa. This includes the structure and performance of its economy (e.g. sluggish economic growth, structural unemployment and significant current account deficits), political and economic priorities (such as those articulated in the NDP), administrative capability and political values (e.g. tax morality and tax culture). In particular, the developments in the South African tax system have to be compatible with constitutional values and aspirations and support the realisation of our first NDP to 2030, *Our future - make it work.* These constitutional arrangements and the NDP are further explored below.

The constitutional dispensation outlines the broad parameters of the South African tax system. In terms of Chapter 13 of the Constitution, the major tax handles, such as personal and corporate income tax (PIT and CIT), Value Added Tax (VAT) and customs duties are assigned to national Government, with provincial governments being assigned very limited own revenue-raising powers (s228). Municipalities exercise more substantial fiscal powers, being able to levy property rates and user tariffs for services such as water, electricity and sanitation (s230). The principle of equality before the law, enshrined in the Bill of Rights, prohibits unfair discrimination in the tax policy on the grounds of race, gender, sex, pregnancy, marital status, ethnic or social origin, colour, sexual orientation, age, disability, religion, conscience, belief, culture, language and birth (s9). The framing of the tax policy should also take into consideration revenue adequacy requirements emanating from justiciable socio-economic rights to education, health, housing etc. to be progressively realised "within the available resources" of the state (ss24-29).

In terms of tax administration, all tax revenues received must be paid into a single National Revenue Fund, to be withdrawn only as a budget appropriation approved by Parliament or as a direct charge approved by the Constitution or an Act of Parliament (s213). Tax administration should also be congruent with the values for public administration as articulated in the Constitution, which are:

1. high standards of professional ethics
2. efficient, economic and effective use of resources
3. development-orientation
4. impartiality, fairness, equity and unbiasedness
5. open to public participation
6. being accountable
7. being transparent
8. being representative.

In particular, taxpayers also have a right to administrative justice including lawful, reasonable and procedurally fair treatment in tax matters (s32) and access to information held by the state.

The 2030 NDP, released in August 2012, is the first long term development plan in South Africa. It significantly extends the planning horizon beyond the five year medium term timespan of the existing departmental five year strategic plans, setting out long term objectives and aiming to strengthen policy coherence.

The NDP attempts to mobilise all South Africans around an ambitious national project to eliminate poverty and reduce inequality by 2030. The Plan provides specific objectives across 13 focus areas underpinned by 119 specific actions.

These areas are: the economy and employment; economic infrastructure; environmental sustainability and resilience; an inclusive rural economy; South Africa in the region and the world; human settlements; education, training and innovation; health care; social protection; safer communities; fighting corruption; nation building and building a capable, developmental state.

The Plan explicitly draws on the democratic developmental state model (pp 54, 407), premised on job creation through accelerated economic growth (pp 109-158) while de-racialising ownership and control in the economy (pp 143, 472), enhancing education quality (pp 294-328), effective skills development (pp 138, 147, 196, 217, 230, 315-329) and innovation (pp 329-332), coupled with building the capability required for a developmental state (pp 407-443). The NDP suggests that strong leadership, effective government and active citizenry are key success factors for building the capacity to identify and act upon opportunities to transform the economy and society (pp 60, 62, 478-481). The strategic application of this capability, anchored in an environment of social cohesion, has the potential to engender a virtuous cycle of development: increased employment and growth, reduced poverty and higher living standards (p 29).

The NDP emphasises that accelerating development requires the support of all citizens and leadership in all sectors, who put the country's collective interest ahead of narrow, short term goals and radically improve Government performance. To this end, one of the 119 actions on the "to do" list of the NDP is to forge a new social compact in the interests of economic growth, employment and equity.

An ambitious goal to which the NDP aspires is the phasing in of National Health Insurance (NHI), permitting the health system to provide quality care to all South Africans, free at the point of service, or paid for by publicly provided or privately funded insurance. The NDP, making reference to the White Paper on NHI, estimates that public health spending will increase from R110 billion in 2010/11 to R256 billion in 2010 prices by 2025/26. As a percentage of GDP, this is an increase from about 4.1% to 6.7%, but the White Paper acknowledges that real costs depend on how it is actually implemented. Critical cost-drivers include: the nature of benefits; the extent to which private providers (private hospitals) are used; the nature of reimbursement mechanisms; how much purchasing is active or passive; the degree of genuine competition; the relative power of purchasers and providers; usage levels of services and how successfully demand is managed.

At this juncture, financing options for the NHI (and hence tax implications) are still being debated. The White Paper points out that stronger sustained economic growth could boost tax yields while expenditure reprioritisation could also free up further resources, but additional taxation cannot be ruled out. In the White Paper a few scenarios are presented for illustrative purposes – these include increases in VAT, payroll taxes and a surcharge on PIT.

Another objective of the NDP is a comprehensive system of social protection by 2030 which would include social security grants, mandatory retirement savings, risk benefits (such as unemployment, death and disability benefits) and voluntary retirement savings. These are to be extended to the informal sector, which would also require public subsidy of contributions. Furthermore, mandatory savings for all working individuals would also reduce disposable income and reduce room for PIT

increases. Both the NHI and the social security reform could also increase the compliance burden on businesses, particularly SMMEs.

Even without the introduction of new policies, changing demographics, such as the ageing of the South African population, will place increasing pressure on health and social assistance spending. The NDP envisages that the number of South Africans over the age of 64 will rise from about 2.5 million now to 4.4 million by 2030 and that this ageing group will be increasingly prone to non-communicable diseases, e.g. cardiovascular diseases. A significant proportion would also be living with HIV and therefore prone to opportunistic infections.

The affordability of these laudable but costly plans is highly sensitive to assumptions around economic growth and job creation. Should the quality of the education system not improve, the labour absorption of the economy remain low and widespread unemployment persist, dependency ratios will increase. Government would then be compelled to maintain the current levels of social security spending on child support grants and old age pensions, but also face increased pressures for funding social protection, education, health and other services.

> Based on the current labour market participation and tax base estimates, there clearly would not be enough tax payers and contributors to ensure state provision, maintenance and sustainability of decent social protection. Social protection benefits will be competing with other priorities for a small pool of funds. And with technology and other advances in medicine, life expectancy is projected to increase, which will require increased spending in the health sector (NDP, 2012:366).

Other objectives of the NDP, which would require additional public resources, include: substantially increasing Further Education and Training enrolment and throughput (pp 30, 50), incentives for research and development (pp 94, 131), public transport (pp 28, 34, 46, 47, 185-189), tax subsidies to business for employing youth and running mentorship programmes (p 138) as well as tax rebates to create incentives for environmental protection (p 206). The NDP also proposes an export tax on minerals (p 147) and supports a carbon tax with a conditional exemption for the electricity industry (pp 171, 178, 212) and a tax on vehicle sales based on their carbon-emission signatures (pp 174, 180).

The central role of leadership in forging and implementing social pacts is vital, especially when there are difficult trade-offs, when the potential benefits manifest after a long and indeterminate interval and accrue differentially to the various development partners (NDP, 2012:282, 475-478). This is of great importance to the tax system since it is an artefact of a social compact between the citizenry and the state. South Africa's record after 1994 in creating and maintaining social compacts has not been impressive. For example, despite a palpable education quality crisis, the education pacts between teacher unions, Government and other sector role players (such as the Basic Education Accord and the Code of Quality Education) have not been fully implemented. The NDP goes on to exhort that "differences and grievances should never be allowed to disrupt education" and notes that a "new agreement will not lead to improvements unless we focus on the obstacles to implementing existing agreements". Unfortunately, short of advocating further engagement and better monitoring of agreement implementation, the NDP says little

about the political management required to align the narrow interests of the elites with the public interest, how the alliance politics would be managed and what would be done differently to ensure better outcomes in the other social compacts which the NDP proposes (such as the spatial compact the NDP envisages).

Fundamental reform, as opposed to incremental reform, of the tax system is also likely to raise profound questions relating to the vibrancy and resilience of the social compact in South Africa. The negotiated transition to democracy had legitimised tax as an instrument for attaining national, democratic objectives, rather than as a mechanism to finance apartheid oppression. This will need to be counterbalanced by the growing disenchantment amongst citizens in relation to perceptions of poor quality of expenditure outcomes, pervasive inefficiency and outright corruption. Thus, for instance, in relation to subnational taxes, ratepayers' associations at local government level have begun withholding payment due to lack of service delivery and impoverished households have engaged in service delivery protests.

As noted in the Katz Commission's first Interim Report in 1994:

> Taxation must be founded on a consensus around the need to nurture the tax system as a vital component of our national existence, in the valued ownership of all the people of South Africa. Although there must be room in a democratic society for energetic debate concerning tax measures, the tax system cannot serve as a forum for protest against other perceived wrongs (p 38).

The status of the "social compact" and nation-building as the unfinished business of the constitutional democracy project will also profoundly impact proposed tax reform, in an environment of increasing inequality and pervasive poverty.

5 TOWARDS A SET OF PRINCIPLES TO GUIDE ASSESSMENT OF THE CURRENT TAX SYSTEM STATUS QUO AND PROPOSED REFORMS

Based on the constitutional, socio-economic, political and policy context facing South Africa, it is important to articulate a set of principles to evaluate the performance of the tax system as it presently operates and to direct any envisaged reforms which the DTC may contemplate recommending. Tax systems around the world generally pursue a number of objectives:

a) Revenue-raising in order to fund Government expenditure is generally the primary objective of taxation.

b) Redistribution of resources to promote social objectives, nation building and social cohesion can be partially effected through the tax system. Pro-poor spending programmes are often a more effective means to achieve this end.

c) Market failures can be corrected by applying a tax on production or consumption to internalise negative externalities, e.g. pollution or consumption of harmful products.

d) Economic policy objectives can sometimes be met by using taxes and tax incentives in targeted ways to support economic growth.

e) The tax system can influence behavioural changes by encouraging certain actions (e.g. savings) and discouraging others (e.g. smoking).

f) International competitiveness is important, although the tax system is not the main driver of international competiveness. Innovation and productivity improvements and the cost of doing business more generally are probably more important. A “race to the bottom” in efforts to maintain the country’s competitive position should be avoided (National Treasury, 2012).

In designing tax policy to achieve Government objectives, the public sector economics literature highlights the importance of the following principles:

1. Efficiency: The tax system must produce sufficient income for the state, with minimum distortions to the economy (i.e. it must be neutral)
2. Equity: All residents must contribute to the fiscus in proportion to their ability to do so. Both horizontal and vertical equity are important. Where appropriate, tax equity should also consider the benefits of the public good received in relation to the tax burden imposed
3. Simplicity*:* As far as possible, taxes should be simple to understand and should be collected in a timely and convenient manner. Compliance costs are thereby minimised
4. Transparency and certainty: The manner in which taxes are collected and the calculation of tax liabilities should be certain. Tax rules and procedures should be transparent and applied consistently
5. Tax buoyancy*:* The tax system should raise sufficient revenue during all phases of the business cycle, while simultaneously embodying scope for a counter-cyclical fiscal framework (National Treasury, 2012).

In practice, pragmatic tax policy design and administration take place in a “second best” world where trade-offs between these principles are the norm rather than the exception. For instance, a tax instrument may be buoyant but not necessarily simple or equitable. Ultimately, the way in which these trade-offs are made is conditioned not only by domestic and global economic realities, but also by political values. This is explored further in Section 9: Trade-offs in structuring the South African tax system: revenue adequacy, growth, inflation and unemployment.

6 THE TAX SYSTEM’S CONTRIBUTION TO FISCAL SUSTAINABILITY IN SOUTH AFRICA

In examining the contribution of the tax system to financing Government activity, it is useful first to consider the evolution of budget aggregates for the broadest definition of government: consolidated general government. General government comprises national, provincial and local government; social security funds as well as foreign technical cooperation accounts and extra budgetary institutions (including universities) with flows between institutions being netted out.

Table 1: Consolidated general government fiscal framework, 2005/06-2017/18

	Outcome									Revised estimate	Medium-term estimates		
R billion	**2005/06**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Revenue	**480.0**	**541.2**	**626.7**	**683.5**	**664.5**	**762.9**	**842.2**	**908.7**	**1 008.1**	**1 091.0**	**1 188.9**	**1 331.5**	**1 439.5**
% of GDP	*30.3%*	*29.5%*	*30.1%*	*29.7%*	*27.1%*	*27.8%*	*27.3%*	*27.3%*	*27.9%*	*28.1%*	*28.4%*	*29.3%*	*29.2%*
Expenditure	**474.8**	**518.4**	**591.5**	**708.5**	**824.1**	**880.0**	**952.3**	**1 044.6**	**1 145.3**	**1 243.4**	**1 351.0**	**1 448.8**	**1 561.7**
% of GDP	*29.9%*	*28.3%*	*28.5%*	*30.8%*	*33.6%*	*32.0%*	*30.9%*	*31.4%*	*31.7%*	*32.0%*	*32.2%*	*31.9%*	*31.7%*
Budget balance	**5.2**	**22.8**	**35.2**	**-25.0**	**-159.6**	**-117.1**	**-110.1**	**-135.8**	**-137.2**	**-152.4**	**-162.2**	**-117.3**	**-122.2**
% of GDP	*0.3%*	*1.2%*	*1.7%*	*-1.1%*	*-6.5%*	*-4.3%*	*-3.6%*	*-4.1%*	*-3.8%*	*-3.9%*	*-3.9%*	*-2.6%*	*-2.5%*

Source: Various Budget Reviews

Table 1 above (reflecting broad consolidated Government aggregates) distinctly illustrates the differences between the period before the 2008 global financial crisis and the actual and anticipated post-crisis period. Before the 2008 crisis, revenue as a percentage of GDP was higher than in its aftermath whereas spending as a percentage of GDP was lower, resulting in modest surpluses or small deficits. The period after 2009/10 saw much lower revenues as a percentage of GDP, coupled with increased levels of expenditure and higher deficits as a percentage of GDP. A concern is that compensation of employees (which is sticky downwards) has formed a much greater proportion of consolidated Government spending, increasing fiscal rigidity and structurally increasing expenditure baselines. Compensation of employees constituted 32.7 per cent of total consolidated expenditure in 2007/08 at the start of the crisis. This had risen to 40.6 per cent in the 2015/16 budget. The Medium Term Expenditure Framework (MTEF) projections in the *2015 Budget Review* anticipated that personnel spending as a proportion of consolidated current Government expenditure would decline marginally to 40.4 per cent in 2017/18. Assuming that cost-of-living adjustments will be aligned with CPI projections and overall headcount numbers remain broadly constant, the consolidated wage bill is expected to grow at a nominal annual average of 6.6 per cent over the MTEF period. Failure to contain increases in the wage could result either in decreased public sector employment (in terms of head count) in an environment where private sector employment growth has been sluggish, or severe pressures for over-spending.

For the purposes of homing in on the tax system and the role of the South African Revenue Services (SARS), a narrower definition of Government finances, such as the main budget, is more useful. The main budget encompasses all nationally raised revenue by SARS and all national Government expenditure, including intergovernmental transfers to provincial governments and municipalities. The main budget revenue excludes revenues raised by provincial and local governments and social security funds (such as the Unemployment Insurance Fund and the Road Accident Fund), as well as their own revenue generated by extra-budgetary institutions. The main budget trends are reflected in Table 2 below.

Table 2: Main budget revenue, expenditure and budget deficit (actual and estimated), 2005/06 to 2017/18

	Actual outcome											Revised estimate	Medium-term estimates		
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Revenue	**299.4**	**347.9**	**411.7**	**481.2**	**560.8**	**608.8**	**579.7**	**672.8**	**745.3**	**800.1**	**887.3**	**954.3**	**1049.3**	**1166.0**	**1265.4**
% of GDP	*23.0%*	*24.0%*	*25.5%*	*26.3%*	*27.0%*	*26.5%*	*23.6%*	*24.5%*	*24.2%*	*24.0%*	*24.6%*	*24.6%*	*25.0%*	*25.7%*	*25.7%*
Expenditure	**328.7**	**368.5**	**416.7**	**470.2**	**541.4**	**636**	**747.2**	**806.0**	**889.9**	**965.5**	**1047.8**	**1135.1**	**1222.3**	**1309.9**	**1420.9**
% of GDP	*25.2%*	*25.4%*	*25.8%*	*25.7%*	*26.1%*	*27.7%*	*30.5%*	*29.3%*	*28.9%*	*29.0%*	*29.0%*	*29.3%*	*29.2%*	*28.9%*	*28.8%*
Budget balance	**-29.2**	**-20.6**	**-4.9**	**11**	**19.4**	**-27.2**	**-167.5**	**-133.2**	**-144.6**	**-165.4**	**-160.5**	**-180.9**	**-173.1**	**-144.0**	**-155.5**
% of GDP	*-2.2%*	*-1.4%*	*-0.3%*	*1.0%*	*1.0%*	*-1.0%*	*-7.0%*	*-4.8%*	*-4.7%*	*-5.0%*	*-4.4%*	*-4.7%*	*-4.1%*	*-3.2%*	*-3.2%*

Source: Various Budget Reviews

While countercyclical fiscal policy may initially have been important to cushion the international shocks emanating from the global financial crisis, there are now serious concerns that the pace of deficit reduction and fiscal consolidation may not be rapid enough.

To support deficit reduction, a nominal expenditure ceiling on main budget non-interest expenditure was introduced by Government in 2012. The 2015 Budget lowered the expenditure ceiling by R25 billion compared with the 2014 Budget baseline over the next two years and increased PIT rates and the General Fuel Levy. The 2015 Budget Review notes, “While fiscal policy has supported the economy for the past seven years, this countercyclical approach has reached its limits. The budget deficit is largely structural and cannot be reduced through a cyclical upturn in revenues” (National Treasury, 2015: 30).

As noted above, containing the wage bill is critical to enforcing this envisaged expenditure ceiling. Should the wage bill growth not be constrained although the expenditure ceiling is enforced, this would result in spending on compensation of employees crowding out other important inputs such as text books, medicines in hospitals, police transport, maintenance of infrastructure and the like.

Table 3 reports the sources of main budget revenues. Between 2005/6 and 2014/15, PIT as a share of total gross tax revenues increased from 30% to 36%, and is expected to increase slightly to 37% over the MTEF period. Over the same period, CIT decreased from 24% to 21% of gross tax revenue, and is anticipated to decline marginally to 20% over the MTEF. The proportion of gross tax revenues raised through VAT remained fairly constant over the period, at around 27%.

Table 3: Main budget revenue sources, 2005/06 to 2017/18, actual and estimated

R billion	Actual collections										MTEF estimates		
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
Persons and individuals	125.6	140.6	168.8	195.1	205.1	226.9	250.4	275.8	309.8	353.0	393.9	433.8	479.2
Companies	98.4	134.3	160.7	185.4	150.4	150.1	173.6	179.0	194.6	206.2	224.5	242.1	262.4
Taxes on property	11.1	10.3	11.9	9.5	8.8	9.1	7.8	8.6	10.5	12.5	13.7	14.8	16.1
Value-added tax	114.4	134.5	150.4	154.3	147.9	183.6	191.0	215.0	237.7	261.3	283.8	313.7	346.7
Excise duties	15.7	17.7	19.7	21.4	22.6	24.6	27.2	30.6	31.4	35.3	38.0	39.2	40.5
General fuel levy	20.5	21.8	23.7	24.9	28.8	34.4	36.6	40.4	43.7	48.5	55.7	57.1	58.8
Taxes on international trade	18.2	24.0	27.1	22.9	19.3	27.0	34.1	39.5	44.7	41.5	42.6	47.2	52.5
Other	13.2	12.4	10.5	11.7	15.7	18.5	21.9	24.8	27.6	28.2	29.2	31.2	33.6
TOTAL TAX REVENUE (gross)	**417.2**	**495.5**	**572.8**	**625.1**	**598.7**	**674.2**	**742.6**	**813.8**	**900.0**	**986.3**	**1 081.3**	**1 179.2**	**1 289.7**
Non-tax revenue	**15.6**	**14.3**	**14.5**	**20.8**	**15.3**	**16.5**	**24.4**	**28.5**	**30.6**	**29.2**	**19.0**	**23.3**	**21.1**
Less: SACU payments	**-14.1**	**-25.2**	**-24.7**	**-28.9**	**-27.9**	**-15.0**	**-21.8**	**-42.2**	**-43.4**	**-51.7**	**-51.0**	**-36.5**	**-45.4**
TOTAL MAIN BUDGET REVENUE	**418.7**	**484.6**	**562.6**	**617.0**	**586.1**	**672.8**	**745.3**	**800.1**	**887.3**	**963.8**	**1 049.3**	**1 166.0**	**1 265.4**

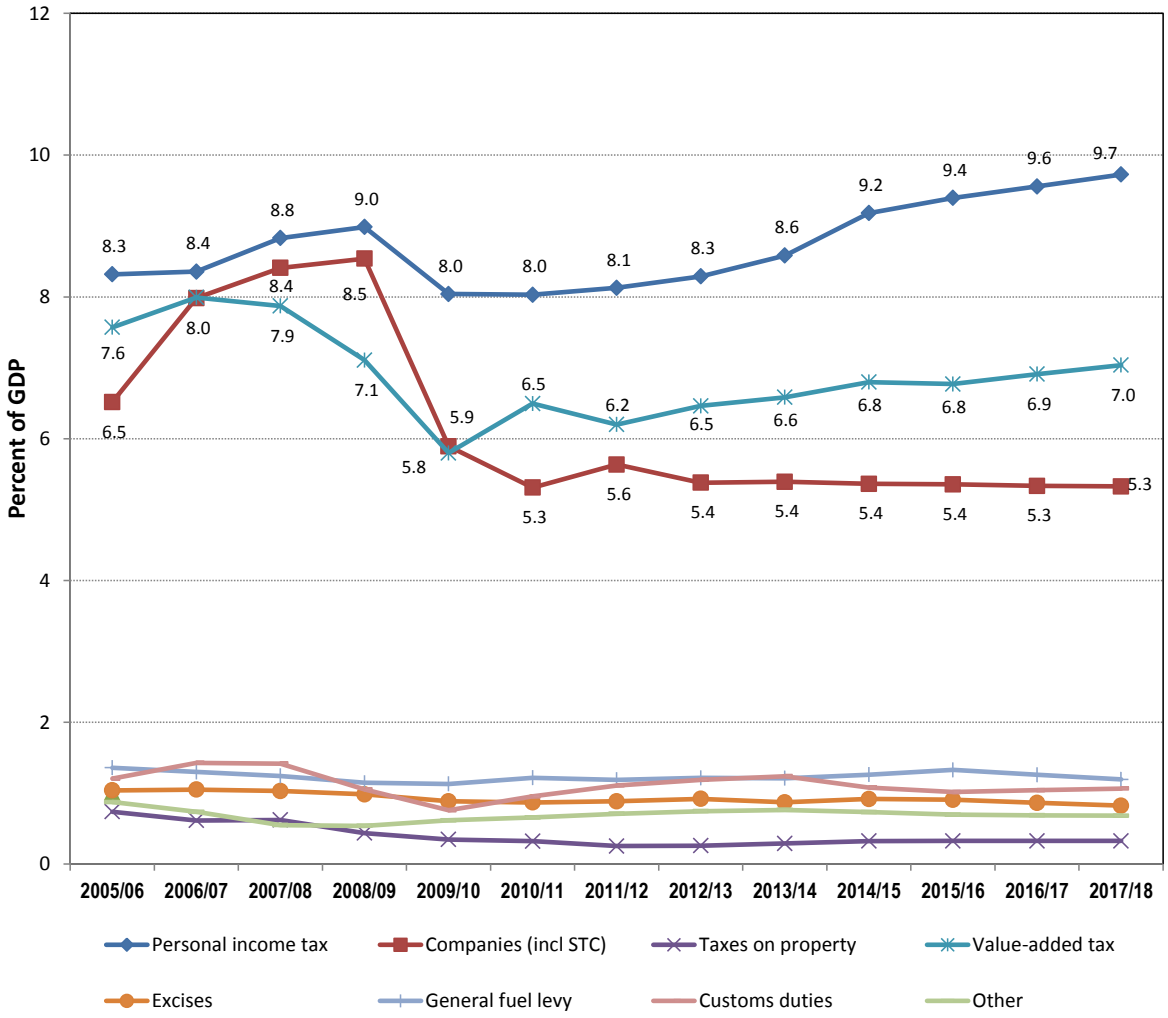
Note: Company tax includes both CIT and Secondary Tax on Companies (STC)
Source: Various Budget Reviews; 2014/15 2015 Tax Statistics

As illustrated in Table 3 above, main budget revenues comprise (a) all tax revenues minus allocations of customs duties to Botswana, Lesotho, Namibia and Swaziland in terms of the Southern African Customs Union (SACU) agreement as well as (b) non-tax revenues which would include interest, dividends, land rental, sales of goods, services and capital assets, fines and penalties, mining and petroleum resource royalties and mining leases. These tables exclude the informal sector, about which very little reliable statistical data is available (see Section 10.4: Tax and the informal sector). The impact of the global financial crisis is obvious in Table 3: the CIT and Secondary Tax on Companies (STC) yield was R165.4 billion in 2008/09, declining to R134.9 billion the following year, and only recovering in nominal terms in 2013/14.

Figure 1, below, disaggregates total gross tax revenue (which includes SACU payments amounting to R51.7 billion in 2014/15) into individual tax handles as a per cent of GDP. This graphic highlights the importance of PIT, CIT and VAT which cumulatively generated more than 80% of total gross tax revenues in 2014/15. The fuel levy, excise taxes and customs accounted for a further 13.3% of total tax revenues.

From Figure 1, it is evident that the contraction of tax revenues in 2009/10 was driven mainly by a significant reduction in CIT and STC yields, which declined from 8.5% in 2008/09 to 5.9% of GDP in 2009/10 and 5.3% of GDP in 2010/11, and has not yet recovered to former levels, languishing at 5.3 per cent of GDP in 2014/15 and projected to remain sluggish over the MTEF horizon until 2017/18. Concomitantly, PIT as a percentage of GDP dropped from 9.0% in 2008/09 to 8.0 per cent of GDP in 2009/10 but has then steadily increased to 9.2% in 2014/15.

Figure 1: Actual and planned gross tax revenue sources as a per cent of GDP, 2005/06 to 2017/18, main budget

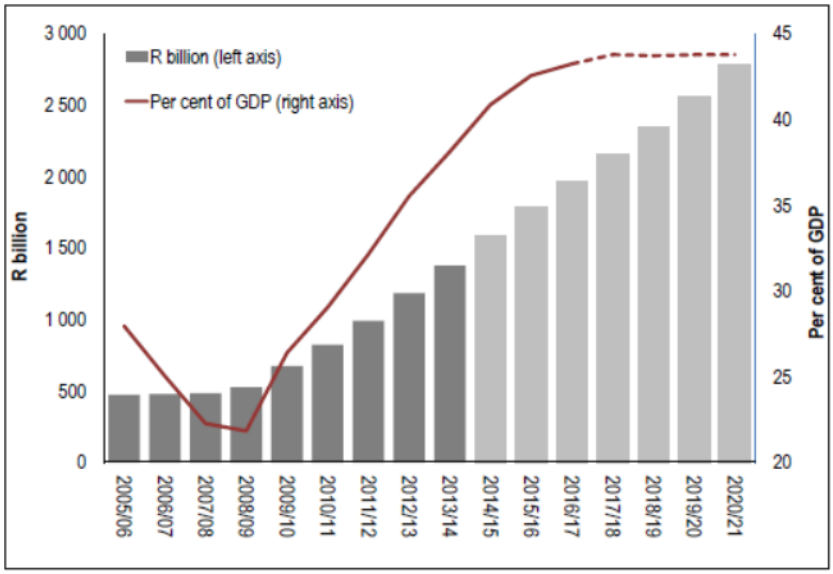


Note: Gross tax revenue includes SACU payments
Source: DTC calculations based on Budget Review 2015 and 2015 Tax Statistics data

Tax yields over the MTEF period will largely be driven by factors such as inflation, high commodity prices, consumption and wage initial settlements and so forth.

Declining tax revenues coupled with increased expenditure after the global crisis in a countercyclical fiscal policy has led to greater deficits as a percentage of GDP, in contrast to the more modest deficits and small surpluses which had prevailed before the crisis. Increased deficit financing has, as illustrated in Figure 2 below, resulted in rapid debt accumulation.

Figure 2: Actual and projected net debt, 2005/6 to 2020/21



Source: National Treasury (2015:30) Budget Review 2015

While net loan debt (gross debt less cash balances) is expected to continue to rise in the MTEF period to 2017/18, Government expects it to level off at 43.7% of GDP in 2017/18. In the 2014 *Budget Review,* National Treasury has advanced three reasons why it deems these debt levels sustainable:

1. Even though global interest rates are expected to rise, domestic interest rates are low by historical standards
2. Foreign denominated debt comprises only about 10% of Government's debt portfolio, limiting the country's exposure to rand devaluation
3. The portfolio has a smooth, long term maturity profile with an average time to maturity of 13 years, which helps cushion against short term capital market fluctuations.

However, there are serious concerns that the pace and intensity of fiscal consolidation might not be adequate to ensure future debt sustainability, with the threat of the country's sovereign rating being downgraded. Be this as it may, this accumulation of debt limits further recourse to substantial further debt financing. This will of course place greater pressures on fiscal consolidation, expenditure reprioritisation and the tax system to ensure adequate revenue to implement Government's plans.

7 AN OVERVIEW OF THE EXISTING SOUTH AFRICAN TAX SYSTEM AND ITS PERFORMANCE SINCE 1994

Having situated the performance of the tax system in relation to broader fiscal policy in the previous section, this section focuses on tax structure and the performance of individual tax handles.

7.1 Tax-to-GDP ratio

The gross main budget tax to GDP ratio rose steadily from the 1960s until 2007/08, when it reached 26.4%. The ratio dipped to 23.5% in 2009/10 as a result of the

global financial crisis, which led to a decline in CIT revenue. The contribution of CIT as a percentage of GDP continued to decline from 8.5% in 2008/09, 5.9% in 2009/10 and 5.3% in 2010/11. In 2011/12 the tax-to-GDP ratio increased slightly as a result of a slight increase in the contribution of CIT, to 5.6%.

Table 4: Recent gross tax revenue as a percentage of GDP, 1995/96 to 2014/15

Fiscal year	Tax revenue as a percentage of GDP
1995/96	21.9
1996/97	22.6
1997/98	23.0
1998/99	23.8
1999/00	23.4
2000/01	22.5
2001/02	23.4
2002/03	22.5
2003/04	22.3
2004/05	23.5
2005/06	24.8
2006/07	25.9
2007/08	26.4
2008/09	26.0
2009/10	23.5
2010/11	23.9
2011/12	24.1
2012/13	24.5
2013/14	24.9
2104/15	25.7

Note: 2015 GDP figures obtained from *Statistics South Africa; Gross Domestic Product (GDP), Quarter 2-2015*
Source: Tax Statistics 2015

The gross tax to GDP ratio however includes South African Customs Union (SACU) payments collected by South Africa and disbursed via a formula to other SACU partner countries. The net tax to GDP ratio is therefore probably a more useful indicator of the evolution of the aggregate South African tax burden.

Table 5: Actual and projected net tax to GDP ratios, 2005/06 to 2017/18, actual and estimated

R billion	Actual collections										MTEF estimates		
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
TOTAL TAX REVENUE (gross)	**417.2**	**495.5**	**572.8**	**625.1**	**598.7**	**674.2**	**743**	**814**	**900.0**	**986.3**	**1 081.3**	**1 179.2**	**1 289.7**
Non-tax revenue	**15.6**	**14.3**	**14.5**	**20.8**	**15.3**	**16.5**	**24.4**	**28.5**	**30.6**	**29.2**	**19.0**	**23.3**	**21.1**
Less: SACU payments	**-14.1**	**-25.2**	**-24.7**	**-28.9**	**-27.9**	**-15.0**	**-21.8**	**-42.2**	**-43.4**	**-51.7**	**-51.0**	**-36.5**	**-45.4**
Other adjustment	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**	**–**
TOTAL MAIN BUDGET REVENUE	**418.7**	**484.6**	**562.6**	**617.0**	**586.1**	**672.8**	**745.3**	**800.1**	**887.3**	**963.8**	**1 049.3**	**1 166.0**	**1 265.4**
Current revenue	**418.6**	**484.6**	**562.4**	**616.9**	**586.1**	**672.7**	**745.2**	**800.0**	**887.2**	**963.7**	**1 049.2**	**1 165.9**	**1 265.3**
Direct taxes	236.3	286.4	339.1	391.7	367.7	389.4	437.9	469.8	521.4	577.5	637.3	696.7	764.3
Indirect taxes	180.7	208.8	233.5	233.4	231.0	284.7	304.8	344.0	378.6	408.8	444.0	482.5	525.4
Other revenue	1.5	-10.6	-10.2	-8.3	-12.6	-1.5	2.5	-13.8	-12.8	-22.5	-32.1	-13.3	-24.4
Sales of capital assets	**0.1**	**0.0**	**0.2**	**0.1**	**0.0**	**0.0**	**0.1**	**0.1**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
Extraordinary receipts	*6.9*	*3.4*	*1.8*	8.2	*6.4*	*3.0*	5.2	12.3	11.7	*8.9*	*2.0*	*5.4*	*2.5*
GDP	**1 510.5**	**1 682.3**	**1 911.2**	**2 171.0**	**2 551.3**	**2 826.1**	**3 080.9**	**3 327.6**	**3 609.8**	**3 843.8**	**4 191.8**	**4 538.8**	**4 926.1**

Source: Various Budget Reviews & 2015 Tax Statistics

The post-apartheid Government's first economic plan, the Reconstruction and Development Programme (RDP) (1993), had spoken of maintaining current fiscal ratios, such as the tax-to-GDP ratio which was then in the region of 23%. It did, however, also propose maintaining current tax *rates* while broadening the tax base, which would result in a mechanistic increase in the tax-to-GDP ratio. As such, it is not clear that the authors of the RDP were ideologically wedded to the idea of keeping the tax-to-GDP ratio below 25%.

In 1996, upon the shift from the RDP to GEAR (the Growth, Employment and Redistribution plan) there was a move to a much more explicit targeting of the tax-to-GDP ratio. The GEAR document had identified considerable scope to effect further reductions in the rates of personal and corporate taxation, while maintaining a ratio of tax to GDP of about 25 percent. Current fiscal policy seems to be continuing to target this ratio. For example, in his 2012 Budget Speech, the Minister of Finance stated that "key features of the budget framework include ... Tax revenue stabilising at about one-quarter of GDP" (Budget Speech, 2012).

What the optimum level of tax revenue as a percentage of GDP should be is both an ideological and a technical, empirical question. The policy stance of the current government on this issue has not been clearly articulated, but the plans for increased spending on NHI and comprehensive social security would suggest that the 25% level is not a hard, strictly binding target. It would be useful for the DTC to obtain some specific guidance from the Minister on this issue. At the same time, it would be helpful to commission some economic modelling on the technical question of what the "taxable capacity" in South Africa is as well as the potential consequences for growth, employment and fiscal sustainability as a result of changing this tax policy variable. At least one existing study (van Niekerk, 2002) suggests that South Africa's tax-to-GDP ratio is relatively low by both international and developing country standards. However, while the average tax to GDP ratio for OECD countries in 2012 was 33.7% (it should be noted that this includes taxes at all levels of government) this includes countries that levy significant social security taxes, which South Africa does not have. When social security taxes are excluded, the OECD average for 2012 was 24.7%. This must be compared to the ratio for South Africa for 2012 of 26.5% when taxes at all levels of government are included. As noted above, the level of taxation has continued to increase since then and is now in excess of 28% of GDP. On this measure, the tax burden in South Africa is higher than the OECD average. The reason for excluding social security taxes is that they significantly distort the statistics and may not provide an accurate indication of the overall level of taxation. For example, social security contributions often replace private retirement, medical or social protection contributions.[1]

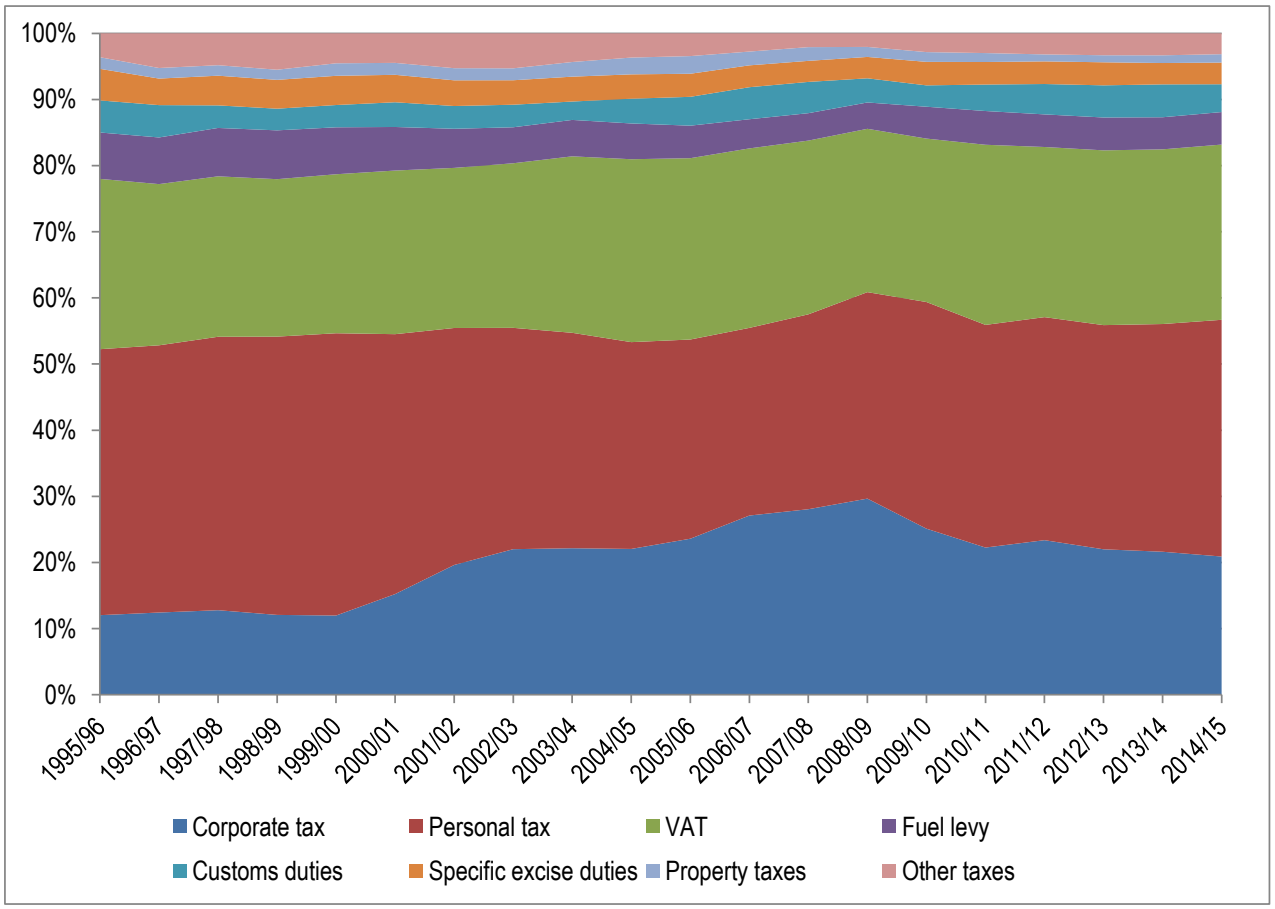
7.2 Tax mix

Figure 3 below, illustrates the shifts in the tax mix since 1994/95. Key features include:

[1] See World Bank data at http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS

- Reliance on direct taxes from individuals (PIT and payroll taxes) initially increased (rising from 40.2% in 1995/96 to 42.7% in 1999/00), then decreased quite rapidly (falling to 28.4% by 2006/07) before rising slowly again to reach 35.9% in 2014/15.
- The share of VAT in gross tax revenue has been fairly stable, ranging from 25.7% in 1995/96 to 27.7% in 2004/05. The share was 26.5% in 20114/15.
- Reliance on CIT (including STC/ Dividend Withholding Tax) as a source of revenue increased markedly, with its share in gross tax revenue rising from 12.0% in 1995/96 to 29.7% in 2008/09. The share has decreased gradually since 2008/09 and was 20.9% in 2014/15.
- Specific excise duties comprised 4.8% of gross tax revenue in 1995/96. This had fallen to 3.3% by 2014/15.
- Similarly, reliance on the fuel levy has also fallen. The fuel levy provided 7.0% of gross tax revenue in 1995/96, falling to 4.9% in 2014/15.
- Revenue from customs duties has fluctuated over the period, reaching a low of 2.8% of total tax revenue in 2003/04 and a high of 5.0% in 2013/14, moving to 4.2% in 2015/15.

Figure 3: Composition of Gross Tax Revenue, 1995/96 to 2014/15

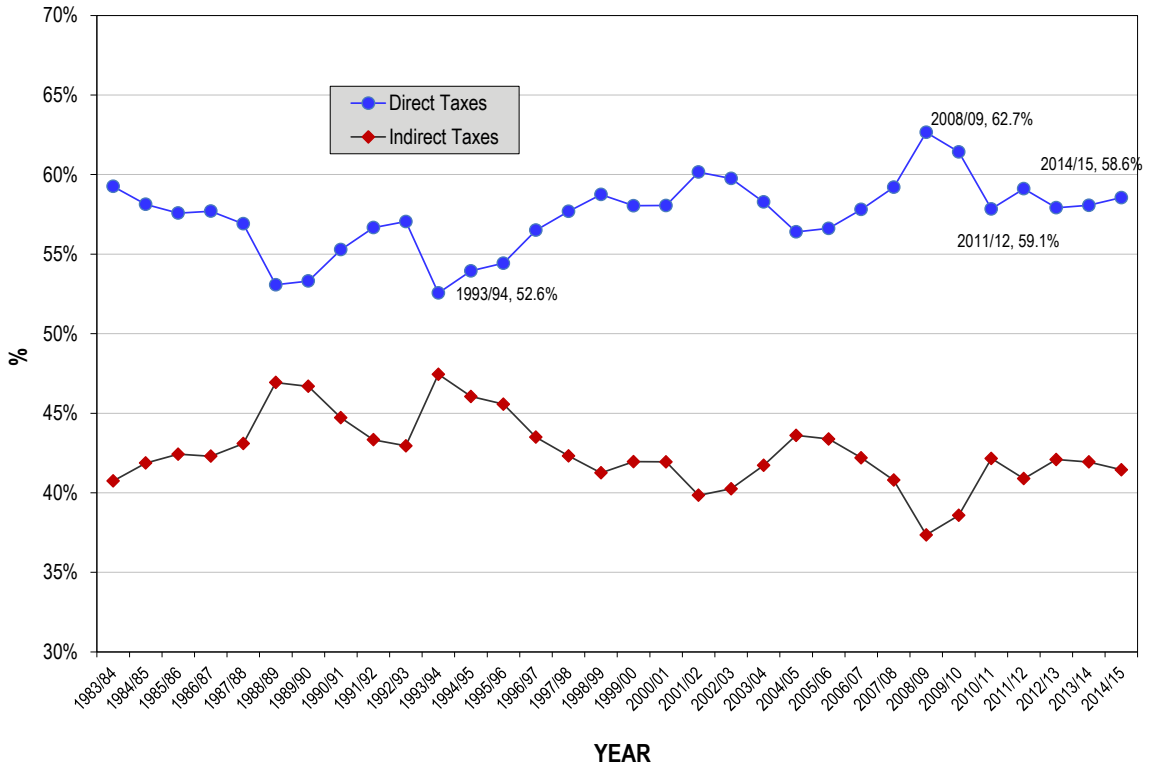


Source: DTC calculations using Tax Statistics, 2008, 2012, 2014 and 2015

Figure 4, overleaf, depicts the mix of direct and indirect taxes over the last 30 years. The proportions have fluctuated quite considerably, with direct taxes making up

anything from 53% to 62% in any given year. The mix between direct and indirect tax fluctuated at but was approximately 58 percent in direct taxes and 42 percent in indirect taxes. A reliance on direct taxes can be expected in an economy with high income inequality. With the introduction of new environmental taxes, it is expected that there will be a slightly larger collection of indirect tax revenues (National Treasury, 2012).

Figure 4: Direct and indirect taxes as a proportion of total (gross) tax revenue, 1984/5 – 2014/15



Source: Special request, National Treasury, 2014. DTC calculations using Tax Statistics, 2015

The skills development levy (SDL) is included in the figures above for taxes on individuals. Under the SDL, employers contribute 1% of their payroll expenses towards training facilitated through the Sector Education and Training Authorities. In addition, employers and employees each contribute 1% of earnings (up to a cap) towards the Unemployment Insurance Fund (UIF) which provides income protection in a case where an employee becomes temporarily unemployed. In general, public finance theory suggests that earmarked taxes should be avoided. However, we would argue that the UIF levy is not a tax but rather a mandatory insurance scheme. All employees must contribute and only contributors can draw benefits. The scheme is entirely self-financing and does not require top-ups from general revenue sources. The case for earmarking the SDL is less clear. These and other earmarked taxes (including those levied by subnational spheres of government) are discussed in Section 11: Subnational taxes, below.

A key insight stemming from the Mirrlees Review is that one should consider the tax system as a whole; implying that not all taxes need to meet all objectives. For

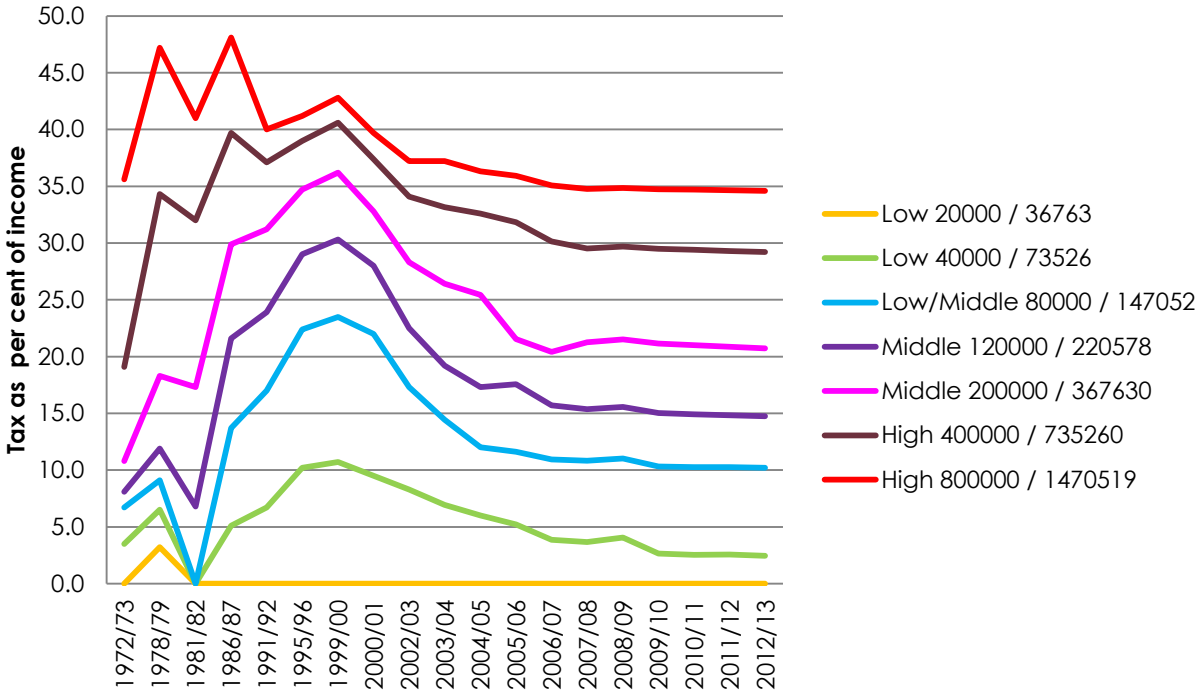
example, so long as the overall system is progressive, not all taxes need to be so (Mirrlees, 2010). Nevertheless, it is useful to briefly consider the three major tax handles: PIT, CIT and VAT and evaluate these in terms of the criteria articulated above, i.e. efficiency, equity, simplicity, transparency and buoyancy. This is discussed further in *Section 14: Assessing the South African tax system against good practice criteria in tax design.*

7.2.1 Personal Income Tax

Numerous tax amendments were made from the late 1980s until the late 1990s. With regard to PIT the focus was on setting the overall framework in place by considering the appropriateness of individual taxation as opposed to joint taxation and married versus unmarried persons' taxation, tax thresholds, income brackets, tax rates and degrees of progressivity as well as fiscal drag and income tax exemptions for charitable, religious and educational institutions. The second phase of post-apartheid tax reforms (from 2000 onwards) focused on broadening the tax base and adapting the tax system to conform to international tax laws. Fundamental changes in phase two culminated in shifting from a source-based to a residence-based system in 2001 and the introduction of CGT to extend the tax base and enhance the equity of the tax system. By 2002, the number of brackets had been reduced to six, the child rebate had been removed and there was a commitment to eliminating fiscal drag through annually adjusting the primary rebate and tax brackets. There is general consensus that the reforms to PIT made the system simpler and more equitable.

Figure 5, below, confirms that there has been substantial PIT relief for all income groups, including high income earners. For example, a married man with two children earning R800 000 at 2000 prices (which equates to about R1.6 million in today's prices) was paying an effective tax rate of up to 48.1% in the 1980s but only 35% today. It is notable that the extent to which the PIT relief from the early 1990s onwards reversed the increases during the 1970s and the 1980s has varied markedly across income groups. The burden on "middle-income groups" remains significantly higher than 40 years ago.

Figure 5: Average PIT rates, various income levels, 1972/73-2012/13 (2000 and 2012 prices)



Source: Presentation by Estian Calitz to the Macro Sub-Committee, 1 October 2013

There are similarly enlightening simulations of the extent of PIT relief between 1995 and 2012 to be found in SARS's Tax Statistics (2013). For example, a person earning R200 000 in 1995, whose income had stayed constant in real terms (and thus grew along with inflation to R556,000 in 2012) faced an effective tax rate of 38.4% in 1995 but only 26.7% in 2012.

In 2012/13 there were 15.4 million registered individual taxpayers. In the 2012 tax year, only 5.9 million individuals were liable to submit tax returns or opted to submit returns voluntarily. 97% of PIT revenue in 2012/13 came from the 2.9 million taxpayers that earned taxable income of more than R120 000 per year (Tax Statistics 2013: 43).

The simplification of the PIT system and the introduction of e-filing have made the system admirably transparent and simple. The threshold for submitting an income tax return has recently been raised again (to R250 000) for employees with a single employer, meaning that the vast majority of workers do not even need to file a tax return.

Loopholes have been closed and deductions have been eliminated or capped. This has enhanced the efficiency of the system as deductions tend to distort. For example, the generous tax treatment of company cars in the 1990s resulted in employees taking more of their salaries in the form of car benefits than they would have done in the absence of the distortionary tax treatment.

The PIT system continues to incentivise certain desirable behaviours through (limited) deductions for medical aid contributions, retirement contributions and saving.

Theoretically, there are concerns that high marginal tax rates disincentivise labour supply (either in terms of participation or working hours). This is of particular concern in countries with sophisticated welfare systems in which the decision to work can result in the loss of social benefits, thus adding to the "tax" on work. This is a non-issue in South Africa as the various means tests for social assistance benefits (such as the Child Support Grant and Old Age Grant) are all well below the income tax threshold. Furthermore, the Minister of Finance announced in 2013 that the means test for the Old Age Grant will be phased out. We could find no South African study on this issue. It would certainly be interesting to try to model the change in behaviour of high income earners under different marginal tax rates. The international mobility of skilled and semi-skilled workers in an internationally integrated labour market represents a further factor in this equation.

The South African PIT system is progressive but does little to reduce overall income inequality. Several studies (Bosch & Roussouw, 2010; van der Berg & Moses, 2006; Inchauste et al., 2015) estimate that the PIT system reduces the Gini coefficient by 2 percentage points. This underscores the point that the PIT system alone cannot dramatically alter the income distribution of South Africa. The majority of South Africans do not participate in this system and thus it cannot directly assist low income households.[2] The impact of PIT on the Gini coefficient is only effected by reducing incomes at the upper end of the income distribution scenario. Despite the highly progressive nature of the PIT system, it barely makes a difference to the yawning gap between the rich and the poor, which is driven by other non-tax factors, such as labour market inequalities.

In terms of tax buoyancy, PIT has demonstrated little sensitivity to the business cycle. While employment fell slightly during the recent financial crisis, salaries and wages did not decline and PIT revenues were not greatly affected.

7.2.2 Corporate Income Tax (CIT)

The legislation for income tax in South Africa was first introduced in 1914 and subsequently amended several times to arrive at the Income Tax Act, 58 of 1962 (IT Act) currently in force, which contains provisions for different types of income tax: normal tax, donations tax, dividends tax, and the smaller withholding taxes (i.e. on interest and royalty payments)

CIT is a tax levied on the taxable income (gross income less exemptions and allowable deductions, and taking into account any assessed losses brought forward from the previous year) of companies and close corporations, all of which are

[2] In a submission to the DTC it was proposed that VAT be increased to facilitate a reduction in CIT. It was argued that "the regressive nature of the tax [VAT] can be addressed through measures such as increasing transfers to households through the social security system, increasing the range of tax-free basic goods and services and providing relief to lower income earners through the personal income tax system". We would argue that this last point is spurious since low-income households typically fall below the tax threshold (although self-evident, this point is overlooked in South African debates and, therefore, worth emphasising).

required to register as provisional taxpayers. CIT is residence-based tax (rather than source based). In other words, companies that are incorporated in or are effectively managed from South Africa are regarded as residents and, subject to certain exclusions, are taxed on their worldwide income irrespective of where such income was earned. Non-residents are taxed only on their income from a South African source, as well as capital gains on immovable property (by way of a withholding tax). Foreign taxes are credited against South African tax payable on foreign income. The determination of the taxable income of taxpayers may be subject to the provisions of tax treaties between South Africa and other countries. Generally speaking, any expenditure (of a revenue nature) incurred in the production of income may be deducted, including interest payments on debt.

Companies are required to make a provisional tax payment within six months of the beginning of the year of assessment while the second payment must be made no later than the last working day of the year of assessment. Taxpayers with taxable income of more than R1 million have to settle at least 80% of their tax liability by the time they make their second provisional payment. Companies that fail to comply with this requirement incur significant penalties. A third provisional payment may be made on a voluntary basis to avoid penalties.

CIT is a significant, but declining, revenue source. In 1975/76 CIT accounted for 41% of tax revenue versus 18.9% in the 2014/15 fiscal year. One of the reasons for this decrease is the drop in the tax revenue from mining, particularly gold mining. Tax revenue from gold mining declined from approximately 10% of total tax revenue in 1975/76 to less than 0.2% in 1998/99 (the last year in which revenue from gold mining companies was reported separately).

Underlying drivers for the decline of CIT relative to other tax instruments post 2008 in the wake of the global economic crisis include: a decrease in global demand for goods and services; substantial increases in domestic electricity prices; increases in the cost of labour, particularly in the manufacturing and mining sectors, and labour conflict.

Capital gains tax (CGT) is not raised separately from CIT. The taxable portion of capital gains is included in CIT taxable income at an inclusion rate of 66.6%. Prior to 1 March 2012, the inclusion rate was 50% and constituted 3.47% of CIT in 2012, down from 5.3% in 2011 (SARS 2013 CIT Product Report). Given that CGT has been in force for about a decade, more research is warranted on its performance and impact since inception.

About 2.9 million companies were registered for CIT in South Africa in 2015. Increases in registrations were driven mainly by the interactive link between SARS and the Companies and Intellectual Property Commission (CIPC) that automatically registers all companies for tax as and when they are registered with the CIPC. Most registered companies are, however, dormant, with just 796 681 expected to submit returns for the 2014 tax year. Expected cases per tax year are defined as all companies that have been assessed for a tax year, plus companies with an “active” status that were assessed in either of the two years prior to the relevant tax year, but do not have an assessment for the year in question. Table 6 below, provides more detail:

Table 6: Number of companies registered for CIT, liable to returns and assessed, 2012-2015

Date	Registered[1]	Percentage growth in register	Tax year	Expected to submit returns[2]	Assessed	Percentage assessed
31-Mar-12	2 034 719	-2.1%	2011	831 477	712 534	85.7%
31-Mar-13	2 195 883	7.9%	2012	832 042	695 759	83.6%
31-Mar-14	2 685 405	22.3%	2013	835 306	652 847	78.2%
31-Mar-15	2 935 385	9.3%	2014	796 681	476 941	59.9%

1. *Excludes cases where status is in suspense or estate or address unknown. The tax year for companies is normally the financial year of the company for financial reporting purposes.*
2. *These are companies that are active and not dormant.*

Source: SARS 2015 South African Tax Statistics:

In 2011, 85.7% of the companies expected to submit returns were assessed, falling to 78.2% in 2013. Just 59.9% of companies have been assessed for 2014. This figure is relatively low because taxpayers have until 12 months after the end of the financial year to submit their returns.

Table 7 overleaf reflects the taxable income of taxpayers assessed in 2013 and the average effective tax rate per income category. Of the 652 847 CIT payers assessed in 2013, merely a quarter of all assessed companies reported positive taxable income (25.5), while a further 29.7% reported assessed losses and the remaining 44.8% reported zero taxable income.. Average effective tax rates may diverge from the statutory CIT rate of 28%, as some companies are liable for CIT at different rates due to special dispensations and deductions. These include personal service providers, non-resident companies, long-term insurance companies, oil and gas companies, gold mining companies and small business corporations (the impact of which can be noted in the R1 to R1 million grouping). Small business corporations are not analysed here since they have been dealt with in a separate DTC Report on the subject.

Table 7: Number of companies by income category, taxable income and tax assessed, 2013

Number	Number of taxpayers	Taxable income (R million)	Tax assessed (R million)	Effective tax rate
Loss	193 856	-499 888	651	N/A
R nil	292 419	–	4	N/A
R1 to R1 million	138 537	26 851	5 867	21.8%
R1 million to R100 million	27 451	179 035	50 405	28.2%
R100 million +	584	375 672	105 942	28.2%
Total	**652 847**	**581 558**	**162 868**	**28.0%**

Source: SARS 2015 South African Tax Statistics

308 large companies with taxable income of more than R200 million each comprised 0.2% of companies with positive taxable income in 2013, but were liable for 58.6% of the tax assessed in 2013, reflecting the high degree of economic concentration in the South African economy (*South African Tax Statistics 2015).*

As illustrated in Table 6, the CIT rate has been reduced over time to the current headline rate of 28%. The divergence between this rate and the top PIT rate (of 40%) presents an opportunity for arbitrage, i.e. high net-worth individuals restructure their income-earning in such a manner that a company, rather than the individual, "earns" the income. SARS has, however, made it increasingly difficult for individuals to do so. In general, analysts tend to argue that the benefits of a lower corporate tax rate (e.g. in terms of making South Africa a more investor-friendly destination) outweigh the negative consequences of this opportunity for arbitrage.

The abolition of the STC and its subsequent replacement by the Dividend Withholding Tax (DWT) introduced in 2012 at a rate of 15%, was widely perceived as an improvement. STC had encouraged corporates to postpone the payment of dividends, as the charging of STC only became effective following the declaration of the dividend. The move to a dividend tax aligns South Africa with the international norm where the recipient of the dividend, not the company paying it, is liable for the tax relating to the dividend. It also makes South Africa a more attractive international investment destination by eliminating the perception of a higher corporate tax rate (since STC is an additional corporate tax) and perceptions of lower accounting profits (STC has to be accounted for in the Income Statement).

Companies which are not tax resident in South Africa, as defined in the IT Act, and are carrying on business through a branch in South Africa, by virtue of having so-called permanent establishment in South Africa, used to be taxed at a slightly higher rate than South African companies on income derived from a source within South Africa. This was in order to compensate for the fact that these companies were not subject to STC. By means of the migration to dividends tax, the rate at which such branches are now taxed was brought in line with other companies (since the dividends tax is payable by the beneficial owner of the dividend, whereas STC was payable by the company) (SARS 2013 CIT Product Report: 4).

The introduction of the dividends tax technically entails that the incidence of tax is not borne by the company paying the dividend but rather by the shareholder receiving the dividend. The legislation, however, requires that the company declaring the dividend acts as an agent for the shareholder, and withholds and pays the dividends tax over to SARS on the shareholder's behalf. There are two exceptions to this general rule, i.e. dividends in specie and deemed dividends, where the company itself retains the liability for the tax. Because the company is effectively responsible for the withholding of the tax, or is itself still liable for the tax, the dividends tax is retained in the CIT stable.

Table 8: Historic Corporate Tax Rates (%): 1994 - 2015

Year	Company	STC/Dividends tax
1994	40	15
1995	40	15
1996	35	25
1997	35	12.5
1998	35	12.5
1999	35	12.5
2000	30	12.5
2001	30	12.5

2002	30	12.5
2003	30	12.5
2004	30	12.5
2005	30	12.5
2006	29	12.5
2007	29	12.5
2008	29	10
2009	28	10
2010	28	10
2011	28	10
2012	28	15
2013	28	15
2014	28	15
2015	28	15

Source: SARS 2013 CIT Product Report, updated with the 2015 Tax Statistics

A joint study by the World Bank Group and PwC, *Paying Taxes 2016,* benchmarks tax regimes in 189 economies in terms of the total tax rate, time to comply and number of tax payments. The study employs a (fictitious) representative case study company to assess the ease of paying taxes through the taxes and contributions paid by a medium sized company and the compliance burden imposed by a particular country's tax system. South Africa attained a fairly high score, ranked 20th out of 189 countries. South Africa's total tax rate was 28.8% in 2015 (comprising 21.7% profit tax, 4% labour tax rate and 3.1% other taxes) which was lower than the world average total tax rate of 40.8% (16.2% average profit tax rate, 16.2% labour tax rate and 8.1% other taxes rate) and the African average of 46.9%.

According to the *Paying Taxes 2016* report*,* this representative company would only need to make seven payments per annum in South Africa, in comparison with the world average of 26.5 and an African average of 36.6 payments. PwC estimated that it would take 200 hours for this fictitious company to complete and file its returns in South Africa, compared to an average of 261 hours in the sample of 189 countries that were surveyed. This indicates that by global standards, CIT in South African is, administratively speaking, relatively simple.

The current headline CIT rate is 28%. However, recent internal work by SARS shows that the average effective tax rate (the ratio of a company's tax liability to its net pre-tax accounting profit) varies enormously by sector. This raises questions about the horizontal equity of the system. This is an area which the DTC could usefully investigate further.

In general, since 1994, CIT rates have declined as the base has been widened, as depicted in Table 6 below. International comparisons are fraught with difficulty since tax bases and other dimensions of tax design and administration vary so markedly. Annexure 3, however, aims to provide a rough international comparison of CIT rates. While South Africa's statutory CIT rate at 28% is lower than the average of North America and for Africa, it falls significantly above the averages for Europe and Asia, as well as the global average rate of 23.68% in 2015, as reflected in the KPMG *International, Corporate and Indirect Tax Survey 2015*.

Efforts have been made to simplify the tax regime for small businesses and to introduce an element of progressivity into the corporate tax regime. These issues are dealt with in detail in the Committee's report on Small Business, and are therefore not covered here.

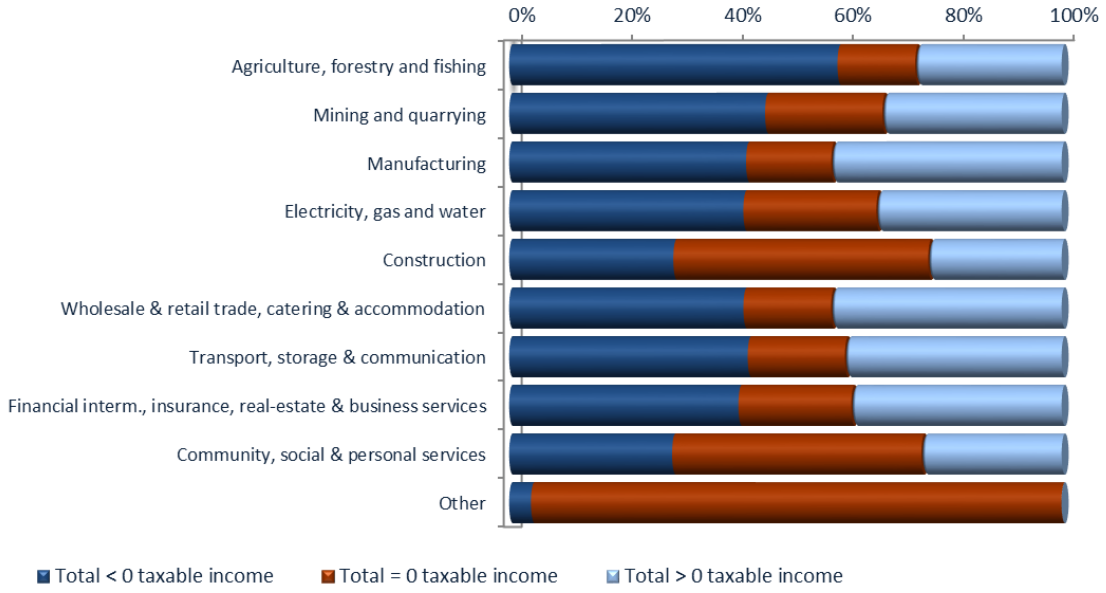
In terms of tax buoyancy, CIT has shown considerable sensitivity to the business cycle, largely explaining the declining share of CIT in total tax revenue from 2009/10 onwards.

7.2.3 Sectoral analysis of CIT

Certain sectors have specific tax dispensations and deductions which cause their effective tax rates to deviate markedly from the statutory rate of 28%. These include the gold mining formula, farming deductions and valuations, as well as the accelerated depreciation of capital assets for qualifying sectors. Small business corporations with a turnover of not more than R20 million qualify for a special tax dispensation in the form of graduated income tax rates, instead of a fixed rate. Micro businesses with an annual turnover of less than R1 million may also elect to pay only turnover tax. This tax has a graduated tax rate structure with a maximum marginal rate of 7%. As part of CIT, companies are required to pay CGT on the disposal of assets.

Figure 6 overleaf records the distribution of taxpayers by economic activity and taxable income groups, for 2013. It illustrates that the agriculture and construction sectors had the greatest number of taxpayers with assessed losses or zero reported income.

Figure 6: Number of taxpayers and tax assessed by economic activity and taxable income group, 2013

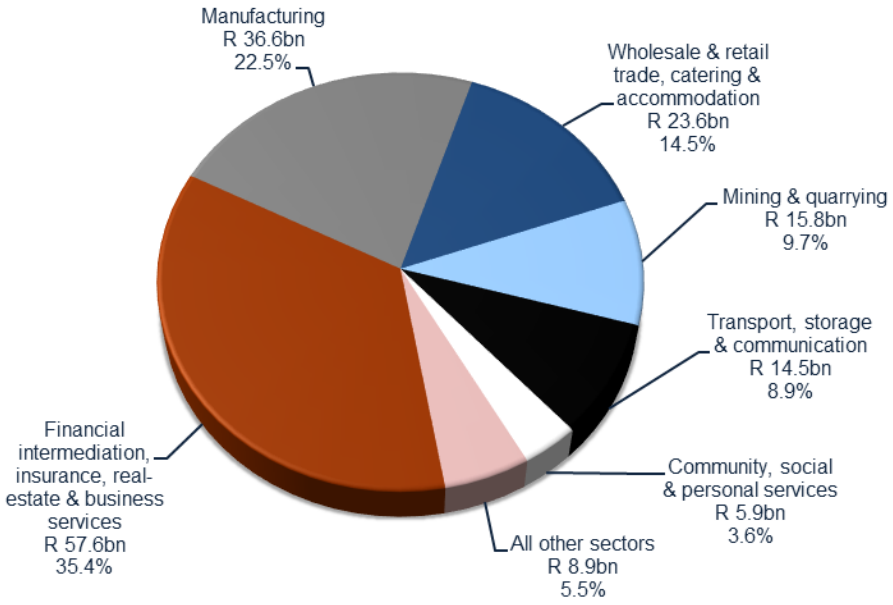


[1] *Because the SARS sector codes are not yet fully aligned with the Standard Industrial Classification (SIC) used by Statistics South Africa, the SARS sector codes have been reclassified in this diagram to align with the SIC.*

Source: SARS 2015 South African Tax Statistics, p135

The financial intermediation, insurance, real-estate and business services sector comprised 27.8% (181 214) of the 652 847 companies assessed in 2013, followed by the wholesale and retail trade, the catering and accommodation sector (13%), the manufacturing sector (8.6%) and community, social and personal services (6.9%). As illustrated in Figure 7 below, the financial intermediation, insurance, real-estate and business services sector was responsible for 35.4% of tax assessed, followed by the manufacturing sector (22.5%) and the wholesale and retail sector (14.5%).

Figure 7: Companies' tax assessed by economic activity, 2013



Source: SARS, South African Tax Statistics 2015

7.2.4 Long term insurers

While short term insurers are taxed at the standard 28% CIT rate, long term insurers are taxed on the "four fund basis":

Four funds	Rate of tax
Corporate fund	28% of taxable income
Individual policyholder fund	30% of taxable income
Company policyholder fund	28% of taxable income
Untaxed policyholder fund: ■ Retirement fund business ■ Other	(abolished from 1 March 2007) 0% of taxable income

7.2.5 Public benefit organisations (PBOs) or recreational clubs

A PBO approved under section 30(3), or a recreational club approved under section 30A(2) of the Income Tax Act, is taxed on its trading receipts. If the PBO or recreational club is a company or the PBO is a trust, they are taxed at the standard 28% CIT rate. The DTC intends publishing a separate report on the tax regime for PBOs.

7.2.6 Mineral and petroleum resource CIT and royalty regimes

The DTC will be releasing a separate mining tax report. This section therefore simply provides just a high level overview of that sector.

While mining is not the largest sector in terms of GDP, it is significant because of its export revenues earned, its unskilled labour absorption potential and its impact on economic growth through upstream and downstream linkages to other industries. As can be observed in Figure 7, the mining and quarrying sector was the fourth largest contributor to CIT, contributing 9.7% of it (R15.8 billion) in 2013. Because exports are zero-rated for VAT purposes, the mining industry's large share of exports renders it a negative VAT contributor. The industry collects Pay As You Earn (PAYE) tax from about 511 000 workers. Between 2002 and 2008, SA's mining Gross Value Added was -0.6% in comparison with 8.5% for its mineral exporting peers, indicating that the industry had missed out on the commodity boom, with negative consequences for CIT collections (National Treasury presentation to the DTC, Mining Sector Contributions to CIT, 30 October 2013). Profitability in the sector also varies markedly, with more than 67.6% of the 2 020 mining companies registered for CIT reporting zero taxable income or assessed losses in 2013.

Because of the peculiar characteristics of the mining sector, most countries, including South Africa, have specialised taxing regimes for the sector. These characteristics include: the high risk and high capital intensity of mining; complex legal and social provisions concerning ownership of mineral resources; the non-renewable character of mineral resources; the employment that mining generates and its political prominence.

In South Africa, mining entities are allowed to deduct capital expenditure incurred from taxable income derived from mining operations (such as expenditure on shaft sinking and mining equipment), as well as expenditure on development and general administration before production commences or during periods of non-production, subject to certain limitations. The capital expenditure incurred on a particular mine is restricted to the taxable income derived solely from that mine. Any excess (unredeemed) capital expenditure is carried forward and is deemed to be capital expenditure incurred during the next tax year of the mine to which the given expenditure relates (ring-fencing). Furthermore, the capital expenditure of a mine cannot be set-off against non-mining income, such as interest, rental, other trading activities and the like. However, where a new mine has commenced mining operations after 14 March 1990, its excess (unredeemed) capital expenditure may also be deducted from the total taxable income derived from mining at other mines operated by the taxpayer, as long as this does not exceed 25% of such total taxable income derived from its other mines.

Companies conducting mining operations are required to rehabilitate areas where mining has taken place and to make provision for rehabilitation expenses during the life of the mine. Amounts paid in cash to rehabilitation funds are allowed as a deduction for income tax purposes.

Most mining companies are taxed at the standard 28% CIT rate. However, there are special arrangements for gold and oil and gas mining operations, described below.

Gold mines

Gold mines are taxed according to a specific formula:

Companies mining for gold (taxed according to the following formula, the "gold mining tax formula")

y = 34 – 170/x

Where:

y = rate of tax to be levied

x = the ratio $\frac{Taxable\ income\ from\ gold\ mining}{Total\ revenue\ (turnover) from\ gold\ mining}$ expressed as a percentage

The aim of the formula is to encourage development of marginal gold reserves in a declining industry.

Before 1 March 2012, gold mining companies could elect to be exempt from STC and were taxed at a higher rate of tax. As a result of the introduction of dividends tax, that option has been removed and gold mining companies are taxed like other companies (SARS 2013 CIT Product Report:4).

Oil and gas companies

Since 2 November 2006, special rules for tax purposes are applied to oil and gas companies regarding their income tax rates, exploration or production or capital expenditures, losses and the like. These are outlined in the Tenth Schedule of the Income Tax Act. The rate of tax on taxable income derived from oil and gas income by any oil and gas company will not exceed 28% on each rand of taxable income.

Effective tax rates (ETR) for mining

Average ETR is a measure of payments to the tax authority as a share of pre-tax profits. ETRs deviate from statutory rates to the extent that the sector intensively utilises deductions, exemptions (e.g. "local dividends received" and "profit on disposal of fixed assets") and other tax incentives. Exemptions lower the amount of tax paid directly (for instance, banks are exempted from paying the 15% withholding tax on the interest received by, or accruing to, a foreign person from a South African source). Deductions for expenses incurred in the course of generating income (such as for spending on capital expenditure, research and development and wear and tear) reduce the amount of taxable income and thereby reduce tax liability indirectly.

Between 2005 and 2011 the average ETR for the mining sector (13.7%) was lower than the all-sector average (18.2%). This sector is one of the largest users of exemptions and accelerated depreciation allowances, as is evident in Table 9 below.

Table 9: Drivers of sectoral ETR differences, 2011

Sector	Total Exemptions	Total Deductions	Total	Contributions
Financial	653	279	932	27%
Mining	537	149	687	20%
Communication	465	77	541	16%
Primary	252	212	464	13%
Manufacturing	205	139	344	10%
General	148	38	186	5%
Retail	103	46	149	4%
Construction	85	63	147	4%
TOTAL (R billion)	2 448	1 002	3 450	100%

Source: National Treasury presentation to the DTC, Mining Sector Contributions to CIT, 30 October 2013

The differential in ETRs may also indicate a misalignment between industrial policy objectives and tax policy in that the sectors with the highest ETRs (vehicles, metal products and clothing) are those supported by industrial policy.

In addition to the substantial variation in ETR across sectors, there is also marked variation within the mining sector and over time. According to analyses between 2004 and 2011 performed by the Large Business Centre, higher ETRs are associated with lower profit levels whereas as profits increase, ETRs diminish significantly. Because expenses claimed for accounting purposes may not be deducted for tax purposes, the taxable incomes and ETRs of some companies may be higher, resulting in ETRs which may exceed the statutory rate.

ETRs are also driven by cyclical factors relating to the underlying profitability of mining subsectors, evincing a downward trend post 2008, especially in the platinum sector.

While average ETRs are important elements in mining investment decision-making, marginal ETRs are also critical in determining the scale of investment. The marginal effective tax rate (METR) gives an indication of the difference across economic sectors of the tax cost associated with R1 of extra investment. It therefore affords an indication of how the effective after-tax returns to new investments differ between sectors. In the South African mining sector, these are low and may even be negative.

> Mining companies are able to immediately write-off all machinery and equipment as well as mine development expenditures at 100%. As can be seen, in the case of equipment (which is assumed to include mine development expenditures in our calculations), the METR is in fact negative 32% because of this immediate write-off provision. This suggests a substantial subsidy to investment in equipment in the mining sector (FIAS, 2006: xiv).

Mining royalties

In addition to normal CIT, mining companies are also subject to a royalty regime. The Mineral and Petroleum Resources Development Act (MPRDA) (Act 28 of 2002), subsequently amended in 2008, vested all mineral rights in the State, as custodian on behalf of South African citizens. In terms of section 3(2)(b) of the MPRDA, the State, in its capacity as custodian, was empowered to determine and levy a fee or consideration payable in respect of these non-renewable resources. This was given operational substance by the Mineral and Petroleum Resources Royalty Act of 2008 (MPRRA) which constitutes the legislative framework for the imposition of royalties on the extraction of the country's mineral and petroleum resources. Resource royalties are not a tax but represent compensation for the exploitation of non-renewable commodities.

In the past, private companies made payment to the State only in certain cases, for instance, where mining took place on State land. With the MPRRA, the mining of all minerals and petroleum resources in South Africa will henceforth require

consideration in the form of mineral and petroleum resource royalties payable to the State.

The MPRRA came into effect on 1 March 2010. Collections by commodity are reflected in Table 10 below. The abnormally high year-on-year growth occurred because the MPRRA was applicable for only part of the financial year in 2010/11, but was applicable for the entire financial year in 2011/12. It is still too early to gauge the ultimate impact of the royalty regime, but royalties do increase cost of production. The royalty on coal, for instance, could place upward pressure on electricity prices, which could undermine competitiveness in other sectors.

Table 10: MPRR payments by commodity, 2010/11 − 2012/13

R million	2012/13	% of total	2013/14	% of total	2014/15	% of total	Year-on-year growth
Coal	436	8.7%	392	6.1%	713	13.2%	82.1%
Copper	48	1.0%	37	0.6%	-	-	-100.0%
Diamond	175	3.5%	107	1.7%	185	3.4%	72.4%
Gold and uranium	1 129	22.5%	838	13.0%	787	14.5%	-6.1%
Industrial Minerals[1]	186	3.7%	278	4.3%	324	6.0%	16.4%
Iron Ore	1 921	38.3%	3 338	51.8%	2 102	38.8%	-37.0%
Manganese	199	4.0%	235	3.7%	115	2.1%	-51.0%
Platinum	461	9.2%	578	9.0%	548	10.1%	-5.3%
Zinc	101	2.0%	48	0.7%	13	0.2%	-72.4%
Other[2]	361	7.2%	588	9.1%	634	11.7%	7.9%
Total	**5 015**	**100.0%**	**6 439**	**100.0%**	**5 422**	**100.0%**	**-15.8%**

1. *Industrial minerals are geological materials which are mined for their commercial value, which are not mineral fuels and are not sources of metallic minerals. They are used in their natural state or after beneficiation either as raw materials or as additives in a wide range of applications (i.e. industrial minerals are all those minerals other than gold, PGMs, coal, iron ore, chrome, manganese, diamonds, etc.).*

2. *The commodities grouped under Other are: Chrome, Fluorspar, Nickel, Oil and Gas, Phosphates, Vanadium and Unspecified.*

Source: SARS 2013 Tax Statistics

Amendments have recently been proposed to the MPRDA and its regulations, which have created a high degree of uncertainty. The DTC has dealt with the mining tax regime in a separate report, as noted earlier.

Carbon tax in the mining sector

The introduction of a carbon tax to curb carbon dioxide emissions will impact greatly on the profitability of the mining sector, but this may differ across sub-sectors, depending on, for example, the intensity of their electricity use. The DTC has already released an interim report on the carbon tax which is available at its website *http://www.taxcom.org.za/*

7.2.7 Corporate tax incentives

There is a plethora of tax and non-tax incentives. The CIT incentives comprise mainly deductions or allowances, although there are also incentives through exemptions. These are all listed in Annexure 2: Corporate income tax incentives. Tax incentives are deliberate departures from tax neutrality in order to change the behaviour of companies in order to promote growth, employment or other policy objectives. It is not clear whether each of these incentives does in fact yield net

benefits to society. The DTC has requested that the World Bank conduct further research into the effectiveness of investment incentives in South Africa, their impact on the user cost of capital and the elasticity of investment to the user cost of capital at firm level. These findings will be released as a separate report.

The World Bank (2015) has already done some work on the quantifying of METRs across various sectors of the South African economy, downloadable from the DTC website. The METR is a measure of the burden of tax on the marginal investment for a profit maximising firm and determines the scale of a project: a higher METR means small size projects and fewer investments. Some of the key conclusions emanating from this study include:

1. South Africa's METR on physical capital is internationally competitive. For manufacturing (with an METR of 15.5%), it ranks 58th out of 95 countries. The tax system is not a major deterrent to investment. However, non-tax issues (e.g. access to reliable electricity, policy uncertainty, labour relations etc.) pose significant challenges to attracting investment
2. There is substantial variation in the METR across sectors. The METR on capital varies from 31.9% for iron ore mining, 23% for the electricity sector, 19.6% for manufacturing to -19.7% for chrome mining. This variation reflects the differences in tax rates across some sectors and the accelerated depreciation allowances. These depreciation allowances reduce the CIT base on which the standard CIT rate is applied, which has the effect of significantly lowering the effective tax burden. The accelerated depreciation allowances generate a "tax advantage" that depends on how the tax rate of deprecation compares to the actual rate of economic depreciation for different asset classes (for example, buildings depreciate far slower than heavy machinery) as well as the actual asset mix/structure of a given sector.
3. Across all sectors examined but one, the METR on capital is lower than the statutory CIT rate of 28%. Thus, while the statutory rate may be somewhat higher than that in other country comparators, accelerated depreciation schedules, investment allowances and interest deductibility act to reduce the effective burden considerably.
4. Incorporating the METR on labour into the overall METR facing investors does not fundamentally alter the finding that the overall burden is still lower than the statutory CIT tax rate. The overall METR when labour is included with capital spans a narrower range, from between 1% for the mining sector to 20% for electricity, gas and water supply sectors. The METR on labour alone varies with the level of average wage in each sector. The METR on labour for firms ranges from just under 5½% in the tourism sector (where average wages are lowest) to about 11% in the electricity, gas and water supply sector (where average wages are highest).
5. The ability to deduct interest from taxable income reduces the METR considerably, even in sectors that receive no specific incentive. The analysis finds that investments in fixed assets funded by high levels of debt have considerably reduced the marginal effective tax rates because of the high levels of debt incurred in many sectors of the economy. The high level of indebtedness in and of itself is a cause of concern, while interest deductibility is globally a major tax policy issue. In this debate, it has been recommended by the Mirrlees Commission in the UK that equity should also be entitled to a deduction at the risk free rate of interest.

6. High inflation has a big impact on the METR, mainly due to its effect on the burden on inventory under First In First Out (FIFO) accounting. This raises the METRs in those sectors in South Africa that have a high proportion of inventory, such as manufacturing (World Bank, 2015).

The significant variation in METRs across sectors suggests further research is needed to assess whether the corporate tax code and system of accelerated depreciation and investment allowances may be (i) encouraging greater capital investment at the expense of labour, (ii) favouring some sectors at the expense of others who offer greater growth and job potential and (iii) generating their intended benefits relative to their cost (World Bank, 2015).

7.2.8 Effective tax rates

With the objective of offering an in-depth analysis of the macroeconomic impact of alternative tax policies aimed at providing the required impetus for promoting economic growth, Amusa (2004) constructed effective tax rates to analyse the implications of tax policy on growth and business cycles in the South African context. Specifically, the author computed time-series estimates of effective tax rates on consumption, capital income and labour income for South Africa, using data contained in South Africa's national accounts and revenue statistics and covering the period 1990 to 2002. Overall, the results reveal that over the sample period, effective tax rates averaged 14, 15 and 28% for consumption, labour income and capital income respectively. Results also indicate that the tax rate on capital is negatively correlated with savings (-0.07) and positively correlated with investment rates (0.42). The positive relationship between capital tax rates and investment might reflect the South African authorities' increased utilisation of tax revenue towards investments in capital projects and infrastructure, a scenario that has complemented private sector investment and activities. On the other hand, the correlation between taxes on labour income and savings is negative (-0.83), confirming theoretical expectations that taxes on labour income tend to reduce the savings of employees (Amusa, 2004). Covering the period 1990-2001, the constructed tax rates in Table 11 below indicate that taxes related to capital have fluctuated sharply where such fluctuations can be attributed to policies regarding transfers, exemptions and the gradual relaxation of restrictions on capital flows. With respect to labour income, taxes reflect an increasing trend in response to improved collection rates. The effective tax on consumption exhibits a constant trend, reflecting that the VAT regime has remained unchanged over the period.

Table 11: Effective tax rates for consumption, labour income and capital income

Year	Consumption	Labour income	Capital income
1990	13.9	13.1	33.9
1991	13.3	13.6	27.7
1992	12.8	14.1	23.5
1993	14.0	13.5	22.0
1994	14.7	14.5	23.0
1995	14.6	14.5	22.2
1996	14.3	15.1	26.0
1997	14.4	16.0	27.7
1998	14.7	16.8	32.2
1999	14.9	17.0	33.3
2000	14.5	16.6	29.8
2001	14.5	17.7	32.2

Source: Amusa (2004).

A World Bank sector study of the effective tax burden in South Africa (FIAS, 2006) takes as its point of departure the argument that tax regimes are one of the pillars of the investment climate and thus have a strong impact on economic growth. It should be noted that one aspect of the analysis is the role and function of the revenue authority, both as the “promoter” as well as the “administrator” of the tax system. The report assesses the tax system (rates, instruments and administration) as it affects existing businesses’ ability to invest and grow, and the ease and efficiency with which new firms can enter the tax net. The study makes use of two complementary tools of analysis: a quantitative measure of the effective tax burden i.e. the METR (which allows for a calibrated comparison between sectors within South Africa and across comparator countries) and a qualitative analysis carried out by sector specialists to assess the effect of the tax system in practice at the firm level).

The main findings of the quantitative and qualitative analyses of the tax/incentive schemes suggest that the overall tax system and incentive scheme, currently stipulated by the income tax code, is broadly appropriate and conducive to growth of the five sectors studied (Agriculture, Manufacturing, Tourism, Financial, Mining); thus, the tax system issues identified, though material, are in general regarded as less pressing than other factors impacting on these industries. The main barriers to growth in these five sectors can be attributed to the other administrative and procedural impediments identified, such as: rand volatility, skills gaps, distortions around input prices and sector specific issues. However, there are issues, within specific sectors but also economy-wide, which merit review and perhaps policy reform (FIAS, 2006).

The DTC has requested the World Bank to update this study of Average and Marginal Effective Tax Rates in South Africa, which will be released as a separate report.

7.2.9 Value-Added Tax

VAT was introduced at a rate of 10% in September 1991, was increased to 14% in April 1993 and has since remained unchanged. There are 19 zero-rated basic commodities (such as maize meal, milk, fresh vegetables and eggs). The list of these commodities has also remained unchanged since 1993.

The efficiency of VAT is maximised when the base is broad and the rate is uniform. There is, however, an obvious trade-off between equity and efficiency. A comprehensive VAT with no exemptions or zero-ratings is certainly regressive. The Katz Commission in its First Interim Report (1994) commented on the possibility of introducing a higher VAT rate on selected luxury goods to mitigate the regressive impact of the tax, but then found that the effect would be "minimal". The Commission claimed that an "extensive set of luxury goods" combined with much higher rates would be required to achieve a meaningful reduction in regressivity. The Commission therefore rejected the introduction of a higher VAT rate on luxury goods, but recommended that targeted poverty relief should be considered instead. The Commission (1994: 123) then asserted that "… it might be possible, based on equity considerations, to improve on the present basket of zero-rated goods" and also recommended that "…the revenue authorities should from time to time systematically review the current basket of zero-rated goods, with reference, inter alia, to the distributional aspects." The DTC's interim report on VAT has dealt with some of these issues.

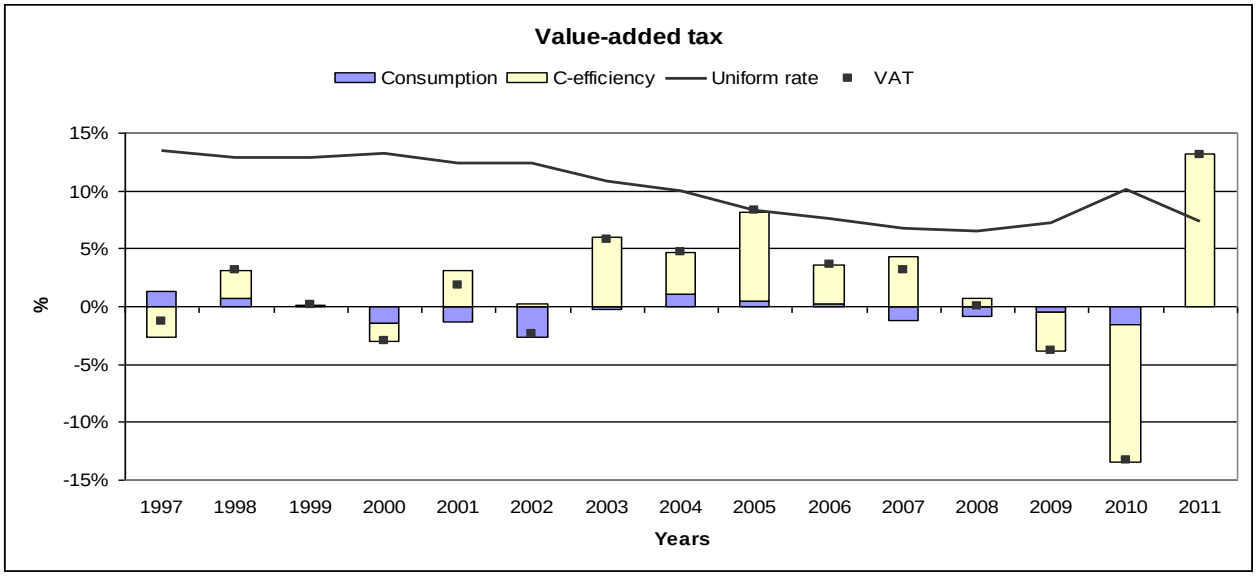
In terms of administration, the current credit-type VAT system is regarded as being the most effective against tax evasion. A large proportion of the tax revenue is collected before the retail stage where evasion is the most likely. In addition, VAT requires the maintenance of records of both purchases and sales, thus providing SARS with a means for cross-checking VAT returns.

The administration of the system becomes more complicated as the number of rates increases, but the magnitude of this cost to business still requires estimation. However, it should also be borne in mind that the introduction of multiple rates could open avenues for tax evasion.

In terms of tax buoyancy, VAT revenues are driven by trends in consumption. Household consumption is less responsive to the business cycle than firms' behaviour; thus VAT is less affected by the business cycle than CIT.

A recent IMF Working Paper, *The Anatomy of the VAT*, prepared by Michael Keen, provides an interesting analysis of the underlying drivers of VAT yields since 1997, illustrated by the diagram in Figure 8, below.

Figure 8: Underlying drivers of VAT collections 1997-2011



Source: Keen (2013)

The paper concludes that the annual percentage change in VAT revenue, as a percentage of GDP since 1997, is chiefly explained by the change in the C-efficiency factor rather than the change in consumption expenditure or the propensity to consume. C-efficiency is an indicator of the departure of the VAT from a perfectly enforced tax levied at a uniform rate on all consumption. C-efficiency represents the existing policy and compliance gaps. Policy gaps include tax refunds as well as zero-rated and exempt supplies. An improvement in the C-efficiency factor indicates either/or both base broadening effects and compliance improvements. The increase in 2011 in VAT revenue, as a percentage of GDP, is explained only by the C-efficiency factor, while in 2010 a decline in the propensity to consume and a decline in the C-efficiency factor contributed to the decline in VAT revenue. The calculated uniform rate on total consumption, given the C-efficiency factor, declined from 13% in 1997 to 7% in 2011, indicating the deterioration of the uniform rate against the standard VAT rate of 14%. One explanation might be the higher levels of openness of the South African economy and thus the higher value of external trade in the economy.

The DTC has requested that the IMF undertakes further analytical research on the potential VAT gap to inform its VAT report.

7.3 Tax administration

Since its creation in 1997, SARS has had remarkable success in improving and modernising tax administration and stepping up enforcement. This has led to reduced tax evasion and tax avoidance, as well as increased tax collections, enabling corporate and individual tax rates to be progressively lowered.

SARS has worked hard to bring more (individual and corporate) taxpayers inside the tax net and made it harder to move outside the net. This institution has made considerable progress in increasing the number of registered taxpayers, which has been achieved in a variety of ways, including education and outreach activities as well as increased enforcement. For example, the number of individual taxpayer

registrations increased from 5.5 million in 2009 to 15.4 million in 2013. It should be noted, however, that the administrative burden of individual taxpayer registration has been largely shifted onto firms. If a firm employs a worker who does not yet have a tax number, the obligation is on the firm to apply for a tax registration number for him/her.

The Tax Administration Act (TAA) of 2011 has simplified tax administration for both SARS and taxpayers. While seeking to further recognise taxpayers' rights, the TAA also grants significant additional powers to SARS. These include greater powers around requests for information from taxpayers and third parties; the power to call individuals to SARS offices for interviews regarding their tax affairs and greater search and seizure powers.

One of the key simplifying features of the TAA is that it provides for a single tax account so that SARS will eventually be able to implement a single registration process for all tax types. This will mean fewer forms and less administration for taxpayers.

SARS has endeavoured to simplify administrative provisions on the basis that it is easier for a taxpayer to fully comply with a law he or she understands. This is in line with a commitment to equity and fairness of tax administration. It is well established that if taxpayers perceive and experience the tax system as fair and equitable, they will be more inclined to fully and voluntarily comply with it.

The PwC report, *Paying Taxes 2014*, notes that the time taken for companies to compile and file their tax returns has been diminishing since e-filing was introduced in 2003. Ongoing administrative improvements have been made, such as the ability of a firm to file a single monthly return in respect of all payroll taxes. PWC does, however, predict that the introduction of TAA will increase compliance costs. In particular, the requirements on certain institutions (notably banks) to provide third party information to SARS will increase such costs.

7.4 Tax expenditures

Tax expenditures are provisions in tax legislation that reduce the amount of tax revenue that could otherwise have been realised through preferential tax treatment for certain taxpayers. In other words they are amounts of revenue forgone by the fiscus in order to favour certain taxpayers. Examples include (1) deductions, exclusions, or exemptions from the taxpayers' taxable expenditure, income, or investment; (2) deferral of tax liability and (3) preferential tax rates. Tax expenditures can be regarded as deviations from the benchmark of a standard tax legislative framework and are equivalent to a Government spending programme implemented through the tax system.

Tax expenditures accounted for 15.6% of total (gross) tax expenditure and 3.8% of GDP in 2010/11 (the most recent year for which data is available). Table 12, below, depicts the gradual increase in tax expenditures over the past few years. The Motor Industry Development Programme's outer year reflects a considerable increase relative to prior years. This is due to a change in the way that data are extracted and a retrospective change that includes heavy duty trucks as part of the heavy motor

vehicle motor industry development programme, implemented at the end of 2010 retrospectively to 2007.

Table 12: Tax expenditure estimates, 2007/08 to 2012/13

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Personal income tax						
Pension and retirement annuity	13 078	15 554	17 966	20 380	22 277	24 393
Pension contributions – employees	*4 774*	*5 765*	*6 765*	*7 647*	*8 344*	*9 083*
Pension contributions – employers	*5 368*	*6 484*	*7 608*	*8 600*	*9 384*	*10 215*
Retirement annuity	*2 936*	*3 305*	*3 593*	*4 133*	*4 549*	*5 094*
Medical	8 544	10 222	12 237	14 808	16 413	19 782
Medical contributions & deductions – employees	*4 750*	*5 696*	*6 917*	*14 808*	*16 413*	*3 901*
Medical contributions – employers	*3 793*	*4 527*	*5 320*	-	-	-
Medical credits	-	-	-	-	-	15 881
Interest exemptions	1 961	2 518	1 730	2 960	1 468	2 202
Secondary rebate (65 years and older)	1 194	1 426	1 061	1 151	1 252	1 330
Tertiary rebate (75 years and older)	-	-	-	0	107	111
Donations	84	107	115	134	167	195
Capital gains tax (annual exclusion)	126	84	88	111	143	292
Total personal income tax	**24 987**	**29 913**	**33 196**	**39 545**	**41 828**	**48 305**
Corporate income tax						
Small business corporation tax savings	1 196	1 279	1 300	1 361	1 455	1 467
Reduced headline rate	*1 174*	*1 254*	*2 380*	*1 343*	*1 434*	*1 450*

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Personal income tax						
Section 12E depreciation allowance	*22*	*25*	*20*	*18*	*21*	*17*
Research and development	358	538	966	1 153	964	343
Learnership allowances	424	397	740	1 144	1 004	689
Strategic industrial policy	228	61	352	740	38	3
Film incentive	297	280	283	185	288	1
Urban development zones	110	159	207	285	390	208
Total corporate income tax	**2 613**	**2 715**	**3 848**	**4 868**	**4 139**	**2 710**

Value-added tax zero-rated supplies						
19 basic food items	13 107	13 907	14 258	15 497	17 106	18 628
Petrol	9 176	10 524	9 660	10 845	13 797	15 343
Diesel	948	1 249	903	1 107	1 532	1 759
Paraffin	516	520	519	367	585	611
Municipal property rates	3 081	3 210	3 973	6 032	7 568	9 598
Reduced inclusion rate for "commercial" accommodation	94	112	127	142	153	175
Subtotal zero-rated supplies	**26 921**	**29 522**	**29 440**	**33 989**	**40742**	**46 115**
Exempt supplies (public transport & education)	**785**	**832**	**905**	**999**	**1 088**	**1 175**
Customs duties and excise						
Motor vehicles (MIDP, including IRCCs)	16 169	12 089	12 089	12 673	16 306	15 823
Textile and clothing (Duty credits – DCCs)	1 829	2 024	2 024	2 230	860	652
Furniture and fixtures	166	128	128	153	150	163
Other customs	1 141	1 231	1 230	787	847	678
Diesel refund (mining, agriculture and fishing)	1 030	1 242	1 993	2 184	2 668	4 137
Total customs and excise	**20 334**	**16 714**	**17 464**	**18 027**	**20 831**	**21 453**
Total tax expenditure	**75 641**	**79 695**	**84 853**	**97 429**	**108 627**	**119 758**
Tax expenditure as % of total gross tax revenue	**13.2%**	**12.7%**	**14.2%**	**14.5%**	**14.6%**	**14.7%**
Total gross tax revenue	**572 815**	**625 100**	**598 705**	**674 183**	**742 650**	**813 826**
Tax expenditure as % of GDP	**3.6%**	**3.5%**	**3.3%**	**3.4%**	**3.5%**	**3.6%**

Source: Budget Review (2014) & Budget Review (2015 for years 2009/10 to 2012/13)

8 ECONOMIC IMPACT OF THE SOUTH AFRICAN TAX SYSTEM: EMPLOYMENT, PRODUCTIVITY, INVESTMENT AND GROWTH

Given the economic importance of the tax system in any country, the dearth of recent, relevant quantitative South African research is surprising. This section highlights the key empirical findings of those studies in South Africa that are available. It should be noted that while a few of the studies do examine the nexus between tax burden and / or structure as regards economic growth, very few of them focus on the employment dimensions as well.

Koch, Schoeman and van Tonder (2005) presented evidence that tax distortions on economic behaviour in South Africa may be much more severe than empirical evidence in other developing countries suggests. Using tax and economic data from 1960 to 2002 and a Data Envelopment Analysis to control for unobservable business cycle variables, the authors examined the relationship between total taxation, the mix of taxation and economic growth. They found that higher taxes are strongly correlated with reduced economic growth potential. Moreover, contrary to the findings of most theoretical research, decreased indirect taxation relative to direct taxation (or in other words, decreases in the tax mix) is strongly correlated with increased economic growth potential. The effects of reductions in income taxes during that period were expected to result in a decrease in the tax burden, which was assumed to be good for the economy. The increased tax mix on the other hand was assumed to be bad for the economy. Due to the estimated elasticities (the tax burden elasticity was found to be 5 times the elasticity of the tax mix), any negative effect from an increase in the tax mix, due to an increase in direct taxes, was expected to be more than offset by the positive effect associated with a reduction in the tax burden.

Finally, the authors' results also suggested that the economic impact of taxes in a developing economy is significantly different from those in a developed economy. The main differences between South Africa and developed economies became apparent in the calculated negative tax mix elasticity. The results implied that tax policy has not been pro-growth.[3] One possible reason for this anti-growth conclusion could be that public resources are not returned to the economy in an efficient manner and/or are not invested in appropriate public goods, so that the double dividend of taxation cannot be realised. In addition, it is feasible that increases in taxes represent a more regulatory approach to the economy, thus discouraging investment. Finally, it is possible that taxation drives economic behaviour underground, so that the reported estimates are overstated (Koch, Schoeman, & van Tonder, 2005). While considering the growth dimensions, the study did not examine employment consequences.

In a more recent study, *Finding the Optimum Tax Ratio and Tax Mix for Maximising Growth and Revenue in South Africa,* Van Heerden (2008) analyses data from 1960

[3] Interestingly enough, Duclos and Verdier-Chouchane (2011) concluded that economic growth in South Africa was not pro-poor either.

to 2007 using co-integration and error correction models to determine the optimum tax ratio and the mix of direct to indirect taxes for maximising growth and Government revenue in South Africa. The Van Heerden paper uses a balanced budget model where Government spending is financed by taxation alone. It abstracts completely from debt dynamics since debt does not exist in her model; therefore any decrease in the tax rate must trigger a commensurate decline in aggregate expenditure. She finds that there is a large difference between the tax-to-GDP ratio which maximises tax revenue and the tax-to-GDP ratio which optimises economic growth (which she estimates at around 19%). She also concludes that the actual aggregate tax burden is above the tax-to-GDP ratio which would maximise growth. Unfortunately, Van Heerden only looks at Government expenditure in aggregate, and does not consider the composition of public expenditure (e.g. gross fixed capital investment or personnel for example). Furthermore, since she modelled only economic growth but not employment, it would not be possible to infer employment impacts from this particular study,

In 2012, Steenekamp (2012b) argued that long-run data on changes in the share of top income earners in South Africa provide evidence that the incomes of the top income groups have become less concentrated for most of the twentieth century, but have become more skewed in the last decade. Compared to a selection of developing and developed countries, Steenekamp concludes that the tax burden (around 21.6% of GDP) is already at a high level, which constrains further exploitation of the tax system for revenue purposes. In his paper, he considered the implications of taxing the rich in South Africa more heavily, so as to address large (taxable) income inequality. Tentative results showed that it is estimated that a 10% increase in the top marginal tax rate would result in taxable income ranging from gains of approximately R2 billion to losses of R340 million, taking into account the impact on the tax base of the higher rates, i.e. behavioural changes. These initial results indicate that taxing the rich at higher rates may not produce the revenue windfall expected. The efficiency loss associated with an increase of one Rand in revenues is estimated at between R0.39 and R3.16. He proposed an alternative to taxing the rich at higher marginal tax rates which could involve reducing tax expenditures that are disproportionately utilised by the rich (Steenekamp, 2012b). As noted earlier, tax expenditures are provisions in tax legislation that reduce the amount of tax revenue that could otherwise have been realised through preferential tax treatment for certain taxpayers.

These results contradict Piketty's assertions that a progressive taxation of wealth and inheritance could be a powerful force restraining the growing power of inherited wealth and limiting inequality (Piketty 2014). Furthermore, Professor Murray Leibbrandt from UCT argued that when the formal policy of apartheid was implemented in 1948, the top 1% of the South African population received about 22% of income, compared to about 9% in France and 11% in the US. By 1975, the share of South Africa's top 1% had dropped to about 10% where it remained until 1991. However, since the end of apartheid it has increased to nearly 20%. Leibbrandt has identified the high unemployment rate as being one of the key drivers of inequality in the country. At the Nelson Mandela Foundation's annual lecture in Soweto, Piketty listed a national minimum wage, a better public education system and a wealth tax as potential measures to address inequality. Specifically, he proposed an annual wealth tax levied on the value of all assets at a rate of 0% tax for those who hold less than R1 million in wealth, a rate of 0.1% for those who hold

between R1 million and R10 million, and a rate of 0.5% for those with more than R10 million. The asset declaration will have the additional effect of building a clearer picture about who owns what in South Africa, and as such designing future inequality measures accordingly.[4] His recent visit to South Africa seemed to have shifted this concept of a wealth tax higher up the African National Congress's (ANC's) agenda, in spite of the call for such a tax having already been made in 1994.

Calitz, Wallace and Burrows (2013) provided a framework and potential methodology for the analysis of tax incentives in South Africa. They argued that the importance of establishing evidence for policies such as tax incentives cannot be overstated; too often, policies march forward with little consideration of the cost-benefit and opportunity cost of specific policy interventions. Their analysis focuses on those incentives aimed at increasing investment, employment and output and those that are employed through the CIT system in South Africa. Initially, they calculated the impact of incentives on the effective marginal tax rate on factors of production (which measures the difference between net and gross rates of return due to specifics of tax policies within a country). A larger decrease in the METR would be expected to bring about greater economic activity. Preliminary analysis demonstrates that relatively simple tools, such as social accounting matrices and Leontief multipliers, can provide policy makers with a means to evaluate the relative value of incentives with respect to their output effects. The models highlighted preliminary evidence of the superior impact of a general tax incentive, such as a reduced corporate tax rate on output (Calitz, Wallace, & Burrows, 2013).

[4] Daily Maverick, "Analysis: Could the ANC's proposed 'wealth tax' work?" 12 October 2015.

9 TRADE-OFFS IN STRUCTURING THE SOUTH AFRICAN TAX SYSTEM: REVENUE ADEQUACY, GROWTH, INFLATION AND UNEMPLOYMENT

It is clear that the fiscus may need to generate additional tax revenue at some point in the future. In particular, if NHI and/or Comprehensive Social Security are to become a reality, the tax to GDP ratio will need to rise quite significantly.

To this end, the Committee requested the National Treasury to undertake a modelling exercise to investigate the macroeconomic impact of increasing tax revenues by about R45 billion in 2014/15. Treasury found that this could be achieved by increasing the standard VAT rate from 14% to 17% or through increasing PIT rates across the board by 6.1 percentage points or by increasing the CIT rate by 5.2 percentage points.

All three scenarios generate the same amount of additional tax revenue. It should be noted that there was no particular rationale for the size of the increase in tax revenue or for proposing that all the revenue should come from just one tax handle – the example is simply illustrative. For the purposes of the exercise, all revenue is "recycled" into Government expenditure in the same proportions as current Government spending. As such, these simulations do not reflect increased spending on a particular item (e.g. health) but, rather, increased overall Government spending in line with the increase in the tax take. Of course, the true impact of the tax increase would depend crucially on how the money is spent.

The effect of a "tax shock", such as the three examples given above, takes time to work its way through the economy. The results recorded in Table 13 overleaf demonstrate the effects of a sustained increase in tax rates two years from now, as outlined above.

From Table 13 , it is evident that an increase in VAT would have the smallest impact on growth. While there would be a negative impact on GDP and employment associated with a rise in the VAT rate, the impact on these two variables would be less severe than if the additional revenue came from increases in PIT or CIT. It is thus clear that from a purely macroeconomic standpoint, an increase in VAT is the least distortionary.

An increase in VAT would worsen inequality whereas an increase in PIT or CIT would reduce inequality slightly. As established in Table 13, inequality in the year 2017 (as measured by the ratio of the richest decile relative to the poorest 4 deciles) would rise by 0.013 in the VAT scenario, versus a decline in inequality in the PIT and CIT scenarios. The decline in inequality is particularly large for an increase in PIT since high income households are primarily affected by the increase in direct taxes. An increase in CIT does not only affect shareholders as it can partially be shifted forwards onto consumers (through higher prices) or backwards onto workers (through reduced salaries).

Table 13: Impact of increased taxation in 2014 on revenue, real GDP and household welfare in 2017

	Impacts by 2017		
	VAT	PIT	CIT
Fiscal Impacts			
Total Direct Tax Revenue	-0.91	8.83	8.29
Total Indirect Tax Revenue	11.56	-1.32	-1.25
Total Tax Revenue	**4.28**	**4.32**	**4.05**
Macroeconomic Impacts			
Real GDP	**-0.65**	**-1.44**	**-2.64**
Agriculture	-2.00	-3.21	-2.66
Mining	1.09	-1.77	-6.75
Manufacturing	-3.25	-4.15	-6.70
Other Industry*	-2.46	-4.12	-11.85
Services	0.06	-0.12	0.03
Welfare			
Household expenditure	-1.83	-5.80	-3.13
Inequality**	0.013	-0.145	-0.022

All values are per cent deviation from baseline level, unless specfied elsewhere
**Includes electricity, water and construction*
***Measured as the ratio of expenditure of the richest 10 versus the poorest 40 per cent*

Source: Special request, National Treasury 2014

This modelling work underscores the efficiency of collecting additional tax revenue via the VAT system. At the same time, it points to the fact that VAT is less progressive than the other tax handles. Given this trade-off between efficiency and equity, if there is a need for additional revenue it would be advisable to adjust more than one tax rate upwards, rather than relying solely on an increase from one tax handle. In addition, the modelling work does not take into account the fact that decreased inequality may have a positive effect on the growth rate; nor the fact that the additional revenue would be spent in specific ways. For example, if the proposed NHI leads to a healthier workforce, this will have a positive effect on growth. The DTC will prepare a separate report on the financing of new government programmes which will look at these issues in greater depth.

10 FISCAL INCIDENCE AND THE SOCIAL IMPACT OF THE TAX SYSTEM

While the previous sections examined the structure of the South African tax system and its recent performance, this section explores the incidence of the tax system with regard to broader social issues, such as poverty and inequality.

10.1 Fiscal incidence

Inchauste et al. (2015) conducted a study of the redistributive impact of the fiscal system using data for 2010/11. On the tax side, the study considered PIT, VAT, specific excise duties levied on alcohol, soft drinks, mineral water and tobacco and the fuel levy. On the spending side, the study investigated cash transfers, free basic services, health and education.

The findings of this study may be summarised as follows:

- Only the top 3 deciles[5] contribute more in tax than they receive in cash transfers, free basic services and in-kind benefits (health, education)

- The PIT system is progressive. As can be seen in Table 14, the wealthiest 20% of individuals generated over 97% of total PIT collections while their share in market income in 2010/11 was equal to 81.4%. Similarly, the wealthiest 10% of individuals generated over 87% of total PIT collections while their share in market income in 2010/11 was equal to 63.7%. The top decile in South Africa pays about 18.5% of its market income in PIT. By way of comparison, the top decile in Brazil pay about 11% of market income in direct taxes (or about 5% of market income in PIT)

- Figure 9 shows indirect takes as a share of disposable income, by income decile. Indirect taxes as a whole are slightly regressive. Up to the seventh decile, the cumulative share of total indirect taxes exceeds their cumulative share of disposable income by a relatively small margin. VAT and the fuel levy are progressive, with all the bottom deciles paying a lower share in such taxes than their share in disposable income. VAT is progressive due to the zero-rating of basic food items.[6] Excise taxes, in contrast, are regressive and the bottom deciles pay a substantially higher share of the total than their share of disposable income. This is a result of the fact that the poor consume proportionately more of the so-called “sin goods”

[5] Households are ranked on per capita “market income”, i.e. income before taxes and transfers. Deciles contain equal numbers of individuals.

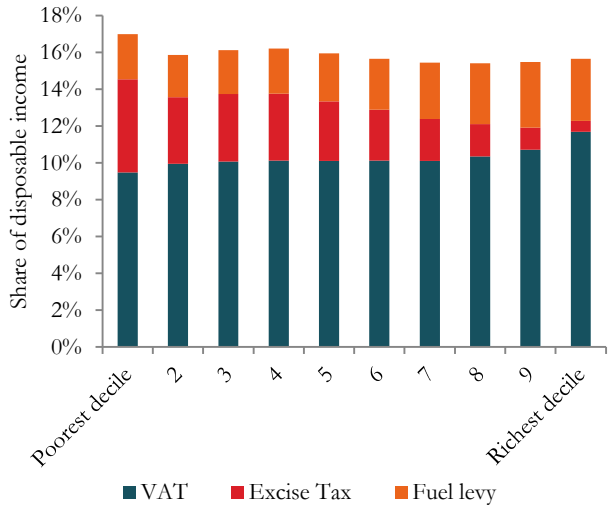
[6] These authors find that if the zero-rating of basic food were scrapped, VAT would be regressive, with the bottom 6 deciles paying a higher share of VAT than their share in disposable income.

Table 14: Share of market income and direct taxes, by decile

Decile	Share of			
	Market income	Direct taxes	Personal income taxes	Payroll taxes
1	0.1%	0.0%	0.0%	0.0%
2	0.2%	0.0%	0.0%	0.0%
3	0.5%	0.0%	0.0%	0.1%
4	0.8%	0.0%	0.0%	0.3%
5	1.5%	0.1%	0.0%	0.8%
6	2.7%	0.2%	0.1%	2.1%
7	4.5%	0.8%	0.4%	4.8%
8	8.3%	2.8%	2.0%	10.2%
9	17.7%	11.7%	10.6%	23.3%
10	63.7%	84.3%	86.9%	58.4%

Source: Inchauste et al. (2015).

Figure 9: Indirect taxes as a share of disposable income, by decile



Source: Inchauste et al. (2015).

Inchauste et al. (2015) find that fiscal policy makes a substantial contribution to reducing market income inequality and poverty. Using income per capita as the welfare indicator, they report that fiscal policy reduces the market income Gini coefficient from 0.771 to 0.596. The reduction in inequality comes largely from the expenditure side of the budget, however, with direct taxes merely reducing the Gini by 2 points (from 0.771 to 0.750).

As Table 15 illustrates, the incidence of extreme poverty (measured as PPP$1.25 per person per day) falls from 34.4% to 16.5%. This includes the combined effect of all taxes, cash transfers and free basic services.[7] Unsurprisingly, direct taxes have no effect on poverty since the poor are almost all below the threshold for the payment of PIT. Indirect taxes exacerbate poverty – in the absence of indirect taxes the poverty rate (using the PPP$1.25 per person per day poverty line) would fall to 11.7%.

Table 15: Poverty and inequality indicators at each income concept, 2010/11

	Market income (1)	Net market income (2)	Disposable income (3)	Post-fiscal income (4)	Final income (5)
		(2) =(1) -- Direct taxes	*(3)=(2)+Cash transfers*	*(4)= (3)--Indirect taxes*	*5=4 + In-kind transfers*
Inequality indicators					
Gini coefficient	0.771	0.750	0.694	0.695	0.596
Theil index	1.222	1.119	0.973	0.971	0.724
90/10	198.9	173.3	32.7	33.2	12.5
Headcount poverty indicators					
National food poverty line[1]	40.8%	41.0%	23.4%	29.0%	–
Official consumption based (food poverty line)	–	–	20.2%	–	–
National lower bound poverty line [2]	46.5%	46.7%	34.2%	39.6%	–
Official consumption based (lower bound)	–	–	32.2%	–	–
National upper bound poverty line[3]	52.3%	52.5%	45.1%	50.1%	–
US $1.25 PPP per day	34.4%	34.4%	11.7%	16.5%	–
US $2.50 PPP per day	46.2%	46.4%	33.4%	39.0%	–
US $4.0 PPP per day	54.3%	54.6%	48.5%	53.1%	–

Source: All data points based on DTC estimates based on IES 2010/11.

[1.] The food poverty line was set at R210 per month in 2005/06 using March 2006 prices. Adjusted for inflation it was R321 per month in 2010/11.

[2.] The lower bound poverty line was set at R300 per month in 2005/06 using March 2006 prices. Adjusted for inflation it was R443 per month in 2010/11.

[3.] The upper bound poverty line was set at R431 per month in 2005/06 using March 2006 prices. Adjusted for inflation it was R620 per month in 2010/11.

Source: Inchauste et al. (2015).

[7] In line with the standard fiscal incidence literature, these authors exclude the monetary value of education and health services in calculating the impact of fiscal policy on poverty rates. This is because households are unlikely to be willing to pay as much as the government spends on these services and as a result do not view these services as part of their income.

The post-fiscal policy situation still represents a situation of great inequality. The post-fiscal policy income inequality in South Africa remains higher than the (pre-fiscal policy) market income inequality in countries such as Brazil. Furthermore, it can be argued that there is only a tenuous link between social spending and social outcomes (van der Berg, 2009).

10.2 Social impact of the tax system

Improvements in tax compliance can be achieved in two ways: either through stricter enforcement and the fear of penalties for non-compliance, or through improved tax morale. The Katz Commission hoped, "…taxation [would become] a legitimate instrument of achieving national, democratic objectives" (First Report of the Katz Commission, 1994:7), i.e. that tax morale would improve as citizens bought into the vision of reducing inequality and creating a "better life for all" through well-targeted social spending, financed by means of taxes. It is difficult to gauge to what extent increased tax compliance has been achieved through better enforcement versus voluntary compliance. It might be possible to find longitudinal attitudinal data; for example from the World Value Survey, which could help answer this question, but as yet we have been unable to discover any analysis of this kind.

10.3 Taxation and gender

Following the recommendations of the first interim report of the Katz Commission, in 1995 South Africa moved away from a PIT system which discriminated on the basis of sex and marital status to a single income tax structure. While this removed the explicit bias in the PIT system, it has been argued (Valodia, Smith, & Budlender, 2001) that the system continues to discriminate against women implicitly by ignoring household structure. The paper does not provide suggestions on ways to address this implicit discrimination but provides useful ideas for issues that the DTC should consider. For example, when undertaking tax incidence analysis of proposed reforms it would be useful to look at the impact on different household structures.

Recent work on gender and indirect taxation (Casale, 2012) shows that the total indirect tax incidence is lower among "female-type"[8] households compared with "male-type" households, a result that holds when controlling for both the expenditure quintile and the presence of children in the household. The findings imply that the indirect tax structure in South Africa is redistributive in a gender-equitable manner. In particular, the zero-rating of a well-targeted basket of basic food items and paraffin, which are consumed relatively more by poor female-type households, has helped to protect these households from carrying a disproportionate share of the indirect tax burden. The high taxes on alcohol and tobacco and the fuel levy contribute to the heavier tax burden on male-type households.

[8] She uses three definitions to classify households as being "male-type" or "female-type." The first takes into account only the presence of adult men and women in the household. The second and third take into account gendered spending power in the household by adding the dimension of control over resources, measured by means of employment status and household headship, respectively.

10.4 Tax and the informal sector

The international literature tends to focus on ways in which informal firms can be formalised in order to bring them inside the tax net. The basic premise is that the informal economy is composed of enterprises seeking to escape from the tax net and therefore the concern is mainly the inability of the tax authorities to reach those operating in the said economy. The thrust is that the informal sector needs to be induced to move towards formalisation in order to broaden the tax base.

Very little has been written about tax and the informal sector in South Africa. One of the few contributions is that of Stern and Barbour (2005) who establish that small firms are deterred from joining the formal sector because of the high cost of compliance as well as low levels of "tax literacy", i.e. small business operators lack the information, education and skills to comply.

While the informal sector in South Africa is relatively small by developing country standards, it nevertheless employs about 2.2 million workers (excluding an additional 1.1 million domestic workers who are sometimes classified as informal workers). While these workers cannot entirely avoid VAT and excise duties and often pay some form of municipal taxes (e.g. for trading rights), they and their enterprises are outside of the net for PIT, CIT, UIF and skills development levies. While the incomes and profits of informal sector workers and their firms are likely to be below the income tax thresholds, it is still desirable for them to be encouraged to be registered. Inducing firms to register so that they pay taxes is an important motivation. Yet the issue is deeper than this. Firstly, the failure to enforce formal status among micro-enterprises risks creating a norm of avoiding taxes even among small firms. Secondly, low rates of enforcement among the smallest firms may encourage firms to remain small in order to continue operating under the radar of the authorities. This might stifle growth in what could be a dynamic part of the economy. Thirdly, avoiding formalisation may contribute to a more widespread culture of mistrust of Government.

An issue that has received little attention internationally – and none at all in South Africa – is the impact of taxation on the informal sector. This is an area that the Committee might want to consider for further research.

11 SUBNATIONAL TAXES AND USER CHARGES

This section explores issues relating to provincial and municipal taxation and user charges, since these also fall within the DTC's terms of reference.

11.1 Provincial tax collections

Provincial tax revenues account for less than 1% of total tax revenue and around 0.2% of GDP. The bulk of provincial tax revenue is derived from motor vehicle licences, with some revenue being derived from casino (gambling) taxes and liquor licences. Few provinces are collecting all the revenues possible from the limited existing tax sources at their disposal.

An argument that has been advanced by the Financial and Fiscal Commission, amongst others, is that increasing provincial tax powers would strengthen accountability at the margin. There is a procedural vehicle for provincial governments to propose new taxes: the Provincial Tax Process Regulation Act of 2001. A

province may, in terms of this Act, propose any tax not strictly prohibited by the Constitution. Section 228 of the Constitution permits provincial taxes, levies and duties other than an income tax, a VAT, general sales tax, rates on property or customs duties. It also authorises provinces to impose a flat-rate surcharge on the tax bases of any tax levy or duty imposed by national legislation other than the tax bases of CIT, VAT, rates on property or customs duties.

In motivating for new tax instruments, provinces would have to provide:

(a) A rationale for the proposed tax

(b) Identification of key policy parameters of the tax

- Tax base or the economic activity or income to be subject to the tax
- Proposed tax rate expressed as a percentage rate applied to the value of the goods or activity or as a fixed rate per unit of sale or consumption
- The person or body legally responsible for paying the tax
- Tax relief measures or exemptions to protect certain taxpayers or activities which otherwise would be included in the tax base

(c) Details of administration

- Tax collection authority, including a stipulation as to whether SARS or another agent would be the collecting agency
- Person or body responsible for actually remitting the tax and the timing of payments
- Methods and costs of administration and compliance enforcement
- Description of the ease or difficulty of taxpayers complying with the tax
- Procedures to assist taxpayers who request information or clarification and procedures for resolving taxpayer complaints

(d) Estimates of revenue and economic impact

- Revenue analysis, including estimates of total revenue to be collected on a quarterly basis over three fiscal years
- Economic analysis of the impact on individuals and businesses in the province
- Economic analysis of the extent to which the tax will be paid by non-residents of the province
- Economic analysis of impact on the province’s economic development

(e) Proof of consultation with interested parties.

The most fiscally buoyant and constitutionally compliant revenue source for provincial governments would be provincial surcharges on PIT and/or surcharges on the fuel levy.

The constitutional requirement, however, that any surcharge be on the tax base of a national tax has been interpreted to mean that a province cannot impose a surcharge as a percentage of the national tax liability due (i.e. a surtax). Rather, the province must design its surcharge as a tax on the underlying income or activity that occurs within its borders. Thus, a province cannot automatically ‘‘piggyback’’ on a national tax.

Certain objections to a surcharge on PIT were raised by National Treasury, both in relation to policy and tax administration. For instance, it was contended that the narrowness of the PIT base would lessen its attractiveness as a provincial-level tax, whereas taxes with a wider revenue base that reflect a large cross-section of the population are more desirable. Furthermore, at that stage there were concerns that such a surcharge might hinder Government's equity and redistribution goals as well as foreclose or complicate other tax reform efforts.

The Katz Commission report on provincial taxation also expressed a number of reservations about a provincial income tax surcharge. As noted earlier, Section 228(1)(b) of the Constitution specifies that any provincial surcharge must be levied at a flat rate on the base of a national tax. In other words, the surcharge must be levied as a percentage of taxable income or activity within the province, not as an additional rate on each taxpayer's national tax liability. The complexity of this requirement, given that a rebate system is used in South Africa, means that a PIT surcharge will not be easy to implement. For instance, a provincial surcharge, which must be imposed at a flat rate for all income classes, may require provisions for low-income protection (exemptions, tax thresholds, credits, and the like) to ensure it does not fall unreasonably on the poor. In addition, under the PAYE system, the residence of taxpayers is not required information. A major problem is lack of data on a taxpayer's province of residence, which is required to properly attribute income for provincial tax purposes. The Katz Commission also warned that other developing countries have encountered significant difficulties in attempting to apply regional or local surcharges on national income taxes, due to the burden on tax administration. Accordingly, the Katz Commission was opposed to a surcharge on the PIT at that stage.

In contrast, the Katz Commission found that a fuel levy surcharge would be more administratively feasible than for PIT, a view shared by the National Treasury. Administering a provincial fuel surcharge would, however, add to the complexity of the current system and require significant cooperation by the oil industry. The analysis also notes that provincial surcharges on fuel could have a significant impact on the national economy, given the key function of fuel as a factor in production and its importance for many different economic sectors. The surcharge on the fuel levy was perceived as having more potential as a viable option in future, but issues regarding consistency with the national economic policy and administrative capacity would need to be addressed.

In further exploring new tax sources for provincial governments, the key issue is whether there have been any changes to these binding constraints.

11.2 Local revenue sources

In contrast to provincial governments, Section 229 of the Constitution confers substantial tax powers on municipalities including property rates, user charges and other taxes, levies and duties, if authorised by national legislation. Various pieces of legislation support Section 229 in the regulation of a municipality's own revenues:

- The Municipal Property Rates Act (MPRA) of 2004 regulates local government's ability to impose property rates

- The Electricity Act of 1987 and the National Water Act of 1998 govern service charges and tariffs specific to the sector
- The Municipal Fiscal Powers and Functions Act (MFPFA) of 2007 regulates all municipal taxes (excluding property rates), including a municipality's ability to apply a surcharge on a tariff and the various "smaller" taxes highlighted in Table 7. Importantly, Section 5 of the Act allows for a municipality or a group of municipalities or organised local government to apply for a new tax.

In practice, however, there is wide variation in the ability of municipalities to generate their own revenues (as illustrated in Table 16 below). Consequently, many municipalities (especially rural and district ones) are highly dependent on intergovernmental grants received from the national Government. In terms of section 214 of the Constitution, the local government sphere is entitled to an "equitable share" of revenues collected nationally by SARS.

Large metropolitan municipalities collectively derived 18% of their revenues from property rates, 45% from water, electricity and other user charges, 3% from investment revenue and 9% from other revenue sources in 2009/10. They were dependent on national Government grants for the remaining 25% of their revenue. Rural municipalities in aggregate derived only 6% of their revenue from property rates, 14% from service charges, 3% investment incomes, 7% from other revenue sources and 70% from national Government grants. Because of their meagre own revenue bases, they are thus greatly dependent on intergovernmental grants (Financial and Fiscal Commission, 2012).

These huge variances in their own revenue capacity across municipalities are conditioned by the highly skewed and concentrated geographic location of economic activity, mainly in urban areas. As illustrated in the table below, low revenues per capita are associated with municipalities with low gross value added (GVA) per capita (a proxy measure for economic activity), high proportions of unemployed people and a large share of poor households. Assigning new tax instruments, therefore, would not necessarily benefit all municipalities, given the underlying spatial skewness in the distribution of the economic and tax base.

Table 16: Municipal Economic and Demographic Indicators – 2007

Type of Municipality	Total population	Total households	Total gross value added per capita	% of people employed	% of households earning below R3200pm	Average population density	Operating expenditure per capita	Revenues from local taxes per capita
Metropolitan municipalties	16,974,424	4,714,021	75.67	34%	46%	1388	3,789.48	*3,279.51*
Secondary cities	8,233,208	2,207,004	50.80	29%	59%	221	2,242.55	*1,940.00*
Larger towns	3,985,216	1,074,513	40.83	27%	62%	87	1,843.08	*1,513.82*
Smaller towns	6,906,926	1,808,666	29.16	22%	69%	19	1,466.46	*988.70*
Rural municipalities	12,331,695	2,673,914	9.44	13%	80%	81	370.49	*120.77*
Total/average	**48,431,469**	**12,478,118**	**41.18**	**25%**	**63%**	**359**	**1,942.41**	**1,568.56**

Source: Financial and Fiscal Commission, 2012

It is a matter of concern that fiscal capacity varies substantially across diverse municipalities and that such capacity appears to have declined over time. In 2004/5, the aggregate own revenues of municipalities amounted to 90% of the aggregate expenditure. At present, this has declined to 75% of aggregate municipal expenditure.

One of the main drivers behind the decline in the municipalities' own revenue capacity and the concomitant increase in grant dependence was the abolition of the Regional Services Council (RSC) levy in 2006/7 because of several legal, economic and administrative shortcomings. Levied by district municipalities and metros on local business turnover and payroll, the RSC levy had constituted a significant own revenue source for local government, accounting for approximately 8% of total municipal operating revenues. To compensate municipalities for this loss of revenue, national Government introduced an RSC levy replacement grant as an interim measure until a suitable replacement for the former tax was identified and implemented. The RSC levies replacement grant was allocated to all district municipalities and metros, based on the amounts they had previously collected through the levies, and was incorporated into the equitable share grant.

In 2009/10, the sharing of the general fuel levy (a national tax) was implemented as the official replacement for the RSC levies for metros (along with the VAT zero rating of municipal property rates). Metros were entitled to an approximate 23% share of the revenues from the general fuel levy (equivalent to the RSC levy replacement grant), shared proportionally among the said metros, according to total fuel sales within their respective jurisdictions. The sharing of the general fuel levy is a direct charge on the National Revenue Account and is annually formalised through the Taxation Laws Amendment Act.

To date, an appropriate own revenue instrument to replace the RSC levy has not yet been found for district municipalities. One of the reasons is that in 2005 the Department of Cooperative Governance and Traditional Affairs (then known as the Department of Provincial and Local Government) announced that the roles and responsibilities of municipalities and provincial governments would be reviewed. This process has yet to be concluded and the roles and responsibilities of district municipalities must be finalised before the identification of a suitable revenue instrument.

The rationale for a local business tax is not only revenue adequacy, but also that local business taxes forge a closer link between the raising of local revenues and their spending. This encourages accountability at the margin, whereas intergovernmental grants vitiate this link. Internationally, municipalities are typically granted the discretion to set local business tax rates in their jurisdictions and, less commonly, the power to set the local tax base. At the end of 2011, eThekwini municipality submitted an application for a new local business tax (LBT) to the Minister of Finance in terms of the Municipal Fiscal Powers and Functions Act. In terms of the proposal, the LBT for economic infrastructure and services would be introduced for South Africa's metropolitan governments, the proceeds of which are to be used exclusively for economic infrastructure and services. Although the Financial and Fiscal Commission had in principle recommended to the Minister of Finance that the LBT be approved, the application had by April 2016 not yet been approved by the Minister of Finance (Financial and Fiscal Commission, 2012).

11.3 User charges and earmarked taxes

Unlike taxes which are largely centralised at national level, the Constitution allows all three spheres of government to levy user charges (section 228 for provinces and section 229 for municipalities). Owing to the e-tolling fees levied by SANRAL on road users in Gauteng province, the issue of user charging has become highly

contentious, politically speaking. In addition, there have been large, recent hikes in electricity and water user charges after long periods of unsustainably low prices as part of demand management. Due to increasing use of public-private partnerships, as well as increasingly requiring state owned enterprises to fund their infrastructure expansion and renewal programmes off their own balance sheets (rather than from general tax revenues), user charging is likely to remain contentious in the near future.

Furthermore, in practice it is often difficult to distinguish between earmarked taxes and user charges. With the NDP articulating ambitious reform programmes both for national health insurance and for social security, earmarked taxes are increasingly being mooted as possible elements of a financing strategy.

A *user charge*, according to the 1993 System of National Accounts, is characterised by:

- a marketable service provided to identifiable beneficiaries
- direct benefits accruing to beneficiaries in exchange for payments made
- transactions taking place in a willing buyer market.

User charges and fees therefore: (1) are excludable (i.e. only the payer receives the specific product or service); (2) have voluntary incidence (i.e. those who do not want the good or service do not pay) and (3) exhibit reasonable congruency between benefit received and the value and timing of payment.

Economic theory suggests that a pure user fee should be set at the marginal costs of provision of a particular service. In practice, user fee pricing can deviate from marginal cost if the good in question has positive externalities, if there are cogent public policy reasons for cross subsidisation or if marginal costs are difficult or costly to determine and average costs are used instead.

In contrast, taxes and levies are general obligations for which:

- payments are compulsory and are enforced in terms of legislation
- no direct benefits accrue to taxpayers in exchange for payments made and
- benefits are returned to groups of people, not identifiable individuals.

Taxes, however, need not be paid into the general National Revenue Fund and allocated as part of the general budget process annually, but may instead be ring-fenced and paid into a special/dedicated fund from which designated expenditures are made. In an *earmarked tax*, the proceeds of a particular tax are designated for a particular purpose, are collected from a general group without approximating individual prices and are unrelated to marginal costs and benefits.

In practice, it is not always easy to distinguish a user charge from an earmarked tax since a financing instrument may be named as a user charge but in essence display the characteristics of an earmarked tax and vice versa. For example, if a public sector organisation were to impose a levy, the revenue proceeds of which exceed the costs of the associated earmarked programme funded, then the portion of the levy used to recover costs would be regarded as a user charge. The proportion of the earmarked levy revenue in excess of the cost of the associated programme would, however, be regarded as an earmarked tax, since its purpose would be

cross-subsidisation, i.e. redistribution to fund other programmes or particular classes of service users (e.g. the poor).

Furthermore, both user charges and taxes may be levied on the *same* base, which may lead to non-transparency, for example in respect of airline tickets where VAT is levied at 14% on each airfare. In addition, SARS levies an air passenger tax on departures from South Africa to foreign destinations (R100 for Botswana, Namibia, Lesotho and Swaziland and R190 for all other destinations in 2015). Moreover, the Airports Company of South Africa levies a passenger service charge to cover airport infrastructure, hand luggage screening, check in facilities etc. The Civil Aviation Authority also levies a passenger safety charge (R16 domestic one-way; R16 on outbound international flights). In addition to these statutory user charges, airlines also add fuel levy charges which go to the airline and an Aviation Coordination Services charge which goes to a non-profit entity created by airlines to provide services such as hold baggage screening, baggage reconciliation and self-service kiosks (Power, 2013, p. 12).

Given that Pigouvian taxes (e.g. an excise tax on tobacco) seemingly cannot internalise the full external cost of a negative externality (such as ill health caused by inhaling of foul air by passive smokers) the question is whether there is a rationale for earmarking income from tobacco taxes for Government expenditure related to combatting the health consequences (e.g. lung cancer). If a proportion or all of the excise tax is, for instance, dedicated to the Department of Health, this accords and institutionalises a high priority to the health problems associated with smoking, elevating its importance above that of other public goods and services (including other health services) which remain subject to the political prioritisation process of allocating common pool tax resources. There is arguably no logical reason why this aspect of the Government budget (i.e. activities related to smoking) should be able to lay special claim to a tax source *once the latter has fulfilled its purpose*, namely, reducing nicotine intake (i.e. reduce the negative externality) to its implied socially acceptable level. Direct and indirect taxes (including tobacco tax) form part of Government's overall revenue, so that with various issues competing for a share of the Government budget, there is no reason why the expenditure on combating, in this instance, nicotine intake, should receive privileged access to funds and thus, why the tax (and by inference, all other externality-related taxes) should be earmarked.

11.4 National Government earmarked taxes and user charges

Prior to 1994, under the apartheid government earmarked taxes had proliferated to fund an array of control boards, research councils, regulatory councils, to bypass the sanctions imposed on South Africa, to fund clandestine activities of the army and police and so forth. While encouraging cost recovery through user charges, the National Treasury has tended to discourage the use of earmarked taxes and dedicated funds on the grounds that they (1) undermine the comprehensiveness of the budget process; (2) introduce additional complexity through fragmentation and (3) allow departments and other agencies to evade the rigour of the annual general budget process.

Some of the most important national earmarked taxes include:

1. The *Unemployment Insurance Fund* which provides short term unemployment insurance to all workers who qualify for unemployment and related benefits as legislated in the Unemployment Insurance Act (2001). The fund is financed by contributions from employees and employers as legislated in the Unemployment Insurance Contributions Act (2002)
2. The *Workmen's Compensation Fund* provides compensation for disablement caused by occupational injuries or diseases sustained or contracted by employees, or for death resulting from such injuries or diseases; promulgated in the Compensation for Occupational Injuries and Diseases Act (1993)
3. The *Road Accident Fund,* in terms of the Road Accident Fund Act (1996), pays compensation for loss or damage wrongfully caused by the driving of motor vehicles in South Africa. It is funded through a fuel levy on petrol and diesel, amounting to 72 cents a litre in 2010/11 and R1.54 in 2015/16. In 2015, Government concluded consultations at the National Economic Development and Labour Council to replace the RAF with the Road Accident Benefit Scheme (RABS). Funded through the fuel levy, RABS will be based on social security principles, moving away from the current liability insurance system.
4. The *National Skills Fund*, established in terms of the Skills Development Act (1998), focuses on national priority projects identified in the national skills development strategy and projects related to the achievement of the purpose of the act, as determined by the director general of the Department of Higher Education and Training. It is financed through the SDL as a percentage of private sector payroll, collected by SARS as part of the monthly PAYE returns and transferred to the National Skills Fund as direct charges against the National Revenue Fund
5. The *Central Energy Fund*, listed in schedule 2A of the Public Finance Management Act (1999), is a private company, which is governed by the Central Energy Fund Act (1977). The act requires the company to research, finance, develop and exploit appropriate energy solutions across the spectrum of energy sources to meet South Africa's future energy needs. In terms of its governing legislation, the company is also mandated to manage the Equalisation Fund, which collects levies from the retail sales of petroleum products to eliminate unnecessary fluctuations in the retail price of liquid fuel and to provide tariff protection to the synthetic fuel industry (SASOL)
6. Environmental levies: The *Electricity Levy* on electricity generated from non-renewable resources was introduced in 2009 at a rate of 2 cents per KWh, increasing to 3.5 cents in 2012. The proceeds are used to fund energy efficient alternatives to carbon based fuels such as the solar water heating programme. The *Plastic Bag Levy,* imposed in 2010 in terms of the Customs and Excise Act of 1964, aimed at promoting the recycling of plastic waste. The *Incandescent Bulb Levy*, also imposed in terms of the Customs and Excise Act of 1964, aimed at promoting the use of electricity-saving light bulbs.

National Government departments and national Government owned entities levy a plethora of user charges, too numerous to list. These include: administrative fees for identity documents, passports, licences and permits, income from property and office rentals, examination fees, inspection fees, fees for resolving insolvent estates, entrance fees to parks and museums, electricity charges (Eskom), port fees etc.

Numerous national public entities also impose their own user fees. The most controversial of these is probably the e-toll fee charged by the South African Roads Agency, SANRAL, but there are a host of other imposts. To name a few: the Universal Services and Access Agency of South Africa (USAASA) levies a charge on suppliers of telecommunication services; the National Energy Regulator of South Africa (NERSA) imposes a charge on suppliers of electricity, piped gas and petroleum; the Council on Medical Schemes (CMS) levies a charge on medical schemes; the National Health Laboratory Services (NHLS) charges fees for laboratory services rendered; the Private Security Industry Regulatory Authority (PSIRA) imposes a levy on private providers of security services; the Cross Border Road Transport Agency (CBTA) imposes permit fees; the South African Maritime Safety Authority imposes a safety levy while the Water Research Council imposes a research levy.

11.5 Provincial Government earmarked taxes and user charges

Section 228 of the Constitution prescribes the submission of a Money Bill to Parliament by the Minister of Finance when provincial taxes, levies or duties are imposed. As noted earlier, the Provincial Tax Process Regulation Act (PTPRA) of 2001 would regulate the introduction of new provincial taxes, earmarked or otherwise. Other provincial taxes levied in terms of sectoral legislation would include casino and horse racing taxes in terms of the National Gambling Act of 1996, motor vehicle licences in terms of the National Road Traffic Act of 1996 and the like.

Provincial impositions of user charges do not fall within the PTPRA; as such fees do not constitute taxes and are therefore not subject to the direct supervision of the Minister of Finance. Provinces are empowered to impose user fees to recover costs reasonably associated with the provision of services set out in schedules 4 and 5 of the Constitution. These include motor vehicle licence fees, hospital fees, liquor licensing fees etc. These user charges would be regulated by the Public Finance Management Act of 1999.

Section 7(2) of the Act empowers the Minister of Finance to make regulations establishing procedures to determine whether a proposed provincial revenue option is a tax or user charge. This distinction is important, as it determines whether a proposed revenue source falls within the ambit of the Act or not.

11.6 Municipal user charges and earmarked taxes

Major sources of revenue for municipalities are user charges on water, sanitation, electricity and refuse removal and so forth. These base tariffs are regulated under the Local Government: Municipal Finance Management Act of 2003 and the Local Government: Municipal Systems Act, 2000. Any surcharges on electricity and other municipal services are regulated by the Municipal Powers and Functions Act of 2007, which also provides a process for imposing new local government taxes other than property rates. The imposition of property rates is regulated by the Municipal Property Rates Act of 2004.

12 A HIGH LEVEL OVERVIEW OF INTERNATIONAL TAX TRENDS

This section presents a high level overview of current and emerging international trends which will impact on the South African tax system, many of which relate to

increased globalisation and the need for trans-national governance structures. The modest aim in this section is simply to identify these factors. An in-depth analysis of these factors, their manifestation and responses will be performed by the Base Erosion and Profit Shifting (BEPS) subcommittee of the DTC and published in a separate report.

12.1 Globalisation

Increased global economic integration has fundamentally affected the tax environment, in general weakening national sovereignty in small open economies, constraining their tax policy space and complicating tax administration. Increased mobility of capital, scarce skills and intellectual property, removal of trade barriers, relaxation of foreign exchange controls and advances in information and communication technology (ICT) have engendered more intense tax competition (generally tending to limit increases in CIT and progressivity of PITs). Vertically and horizontally integrated multinational enterprises (MNEs) catering to global markets have become increasingly dominant, drawing on supply chains which transcend country borders and exploit low-tax regimes and tax havens. This has created a need for a move beyond transnational cooperation to active collaboration, such as joint and simultaneous audits, shared risk assessments and using tax treaties in order to achieve a more coordinated approach to compliance by MNEs.

This collaboration has been slow to emerge, given that the existing international tax system has been based on bilateral treaty agreements (e.g. double taxation) between two countries to coordinate their respective taxing rights. Under current tax regimes, no single national tax authority sees the complete accounts of a MNE as a whole and has to rely on information exchange with countries with which it has concluded bilateral tax treaties. So-called “tax havens” have, however, in the past, largely not engaged in the practice of broad information exchange. MNEs which have exploited these tax havens have therefore obtained significant competitive advantage resulting in socially inefficient investment decisions and distortions in economic activities. Large scale systematic tax avoidance or evasion by large MNEs not only diminishes the revenues available to governments and inhibits their ability to implement policy objectives but also, by creating perceptions of unfairness, undermines the legitimacy of the tax system as a whole.

12.2 The aftermath of the 2008 global financial crisis

The global financial crisis has had a lingering aftermath and has transmuted into a sovereign debt crisis in the European Union, a major trade and investment partner for South Africa. Causes of the crisis have been attributed to multiple and complex interacting factors: excessive debt-fuelled consumption in developed countries; globalisation and deregulation of financial markets; acceleration in financial innovation resulting in non-transparent financial structures, unsupported by underlying assets, as well as greed rewarded by poor governance and oversight. Government bail-outs to failing financial institutions have massively increased government sovereign debt, compromising fiscal sustainability and pushing weak governments to the point where they themselves have required bailouts. This, coupled with the need to stimulate ailing domestic economies, has created pressures for radical fiscal consolidation. In South Africa, these uncertain and trying economic circumstances were compounded by domestic economic shocks (e.g. pervasive labour conflict, such as Marikana).

12.3 Base erosion/Profit shifting

The recent financial crisis exposed weaknesses in international financial governance, uncovering sophisticated tax avoidance schemes, which would require an internationally coordinated response. Globalisation has created greater scope for MNEs to engage in aggressive tax planning and outright evasion. Some of the modalities include:

1. Moving earnings from a higher tax country to a lower tax one through, for example, internal group leverage, such as primarily financing subsidiaries in high tax countries by debt. Interest on debt is generally tax deductible whereas dividends are typically paid out of after tax income, creating a bias induced by the tax regime towards debt financing over equity. A finance company would be set up in a low tax jurisdiction and would make loans to companies in high tax jurisdictions for which the interest payments are tax deductible. The flow of interest payments to the finance company in the low tax jurisdiction would also attract little or no tax
2. Profit shifting through transfer mispricing, that is, by setting prices for intra-group transactions that are inconsistent with what unrelated parties would do, especially from countries where no transfer pricing legislation exists or it is poorly enforced. Once it is ascertained that a share of an MNE's profits derives from a particular country which then has the right to tax it, transfer pricing rules determine the relevant proportion of an MNE's profits which will be taxed. The internationally accepted principle for transfer pricing is the arm's length principle. This requires that related parties in an MNE should, for tax purposes, "allocate income as it would be allocated by independent entities in the same or similar circumstances", i.e. consistent with what market forces would have determined based on the functions performed by each enterprise, the assets they employ and the risks assumed
3. Arbitrage opportunities resulting from differences between tax regimes, for example through the use of "hybrid" instruments (which may lead to a deduction in one jurisdiction without corresponding taxation in another jurisdiction). Hybrid financial instruments have characteristics typically associated with debt as well as features typically associated with equity. For instance, payments under the instrument may be regarded as tax deductible for an MNE in one country but might be regarded as dividends in another country and hence be exempt from taxes.

BEPS has been exacerbated by countries which have developed highly favourable regimes to attract profits and tax receipts (that is, tax base shifting) away from the countries where investment actually takes place. Tax havens enable extensive tax avoidance and evasion as well as the laundering of the proceeds of crime and corruption. Pricing of intellectual property (such as franchise fees) is particularly difficult. By way of example, a Sky News article in October 2012 revealed that for the previous year, the American company, Starbucks, had declared no taxable income despite having hundreds of profitable franchises (*Sky News*, 16.10.2012). It is extremely difficult to quantify the prevalence of BEPS behaviours precisely, but several studies reveal a trend towards increasing separation between the location where actual business activity and investment takes place (proxied by sales, employment, payroll and fixed assets) and the location in which MNEs report profits for tax purposes (OECD, 2013a).

To combat BEPS, policy responses have aimed to align the right to tax more closely with the actual location of economic activity. These responses include:

1. Tightening up general anti-avoidance rules (e.g. the detection of aggressive tax planning and deterrence measures, such as issuing public rulings, penalties and additional reporting requirements)

2. Specific (or targeted) anti-avoidance rules such as:
   (a) Controlled foreign company (CFC) rules (whereby base eroding income reported by non-resident controlled entities is attributed to domestic shareholders and taxed accordingly, irrespective of whether the income has been repatriated or not)

   (b) Thin capitalisation and other rules limiting interest or other financial expense deductions (if, for instance, the debt-to-equity ratio of the debtor is considered excessive)

   (c) Anti-hybrid rules which link the domestic tax treatment of an MNE with its tax treatment abroad in order to eliminate mismatches which result in double taxation or no taxation at all

   (d) Anti-base erosion rules which may impose higher withholding taxes on certain payments or deny their deductibility (e.g. payments made to entities in certain locations).

Most impoverished developing countries do not, however, possess the human capital or other resources to implement the complicated, specific anti-avoidance rules such as the time consuming checks on transfer pricing required by the OECD approach.

12.4 The digital economy, e-commerce and intellectual property

Historically, in order to determine whether a country has tax jurisdiction in respect of the business profits of a non-resident MNE, international tax treaties have used the principle of permanent establishment. This encompasses not only a substantial physical presence of a non-resident MNE in a particular country, but also the case where the MNE uses a dependent agent to conduct business. Increasingly, however, the “knowledge economy” and e-commerce have become more globally important, undermining the established permanent establishment principle. As a result of internet penetration permitting the sale of digital products such as music and films, companies could maintain a virtual presence in other countries without a physical presence there and thus pay no taxes at all.

13 INTERNATIONAL TAX REFORM EXPERIENCE IN PROMOTING INCLUSIVE GROWTH: DEVELOPED AND DEVELOPING COUNTRIES

As noted in the section above, tax systems are unique, having evolved over centuries in response to specific country contexts, making cross-country comparisons very difficult. Although tax systems tend to be primarily aimed at financing public expenditures they may also be used to promote other objectives, such as equity, and to address social and economic concerns. They need to be set up to minimise taxpayers’ compliance costs and governments’ administrative cost,

while also discouraging tax avoidance and evasion. However, taxes also affect the decisions of households to save, supply labour and invest in human capital, the decisions of firms to produce, create jobs, invest and innovate, as well as the choice, by investors, of savings' channels and assets. Of significance for these decisions is not just the level of taxes but also the way in which different tax instruments are designed and combined to generate revenues (i.e. the tax structure) (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

The effects of tax levels and tax structures on agents' economic behaviour are likely to be reflected in overall living standards. As a result, over the past decades many OECD countries have undertaken structural reforms of their tax systems. Most of the PIT reforms have endeavoured to create a fiscal environment that encourages saving, investment, entrepreneurship and provides increased work incentives. Most corporate tax reforms have been driven by the desire to promote competition and avoid tax-induced distortions. Almost all of these tax reforms can be characterised as involving rate cuts and base broadening in order to improve efficiency, while at the same time maintaining tax revenues (i.e. budget-neutral reform) (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

A 2008 OECD report, representative of contemporary mainstream developed countries' perspectives, focused on the effects of changes in tax structures on GDP per capita and their main determinants. Although it is difficult to completely separate the analysis of the overall tax burden from that of tax structure, the report focused on *tax structures rather than levels* because cross-country differences in overall tax levels largely reflect societal choices about the appropriate level of public spending, an issue that is beyond the scope of tax policy analysis. Nonetheless, investigation of how tax structures could best be designed to promote economic growth is a key issue for tax policy making. Furthermore, it is difficult to fully disentangle the revenue-raising function of the tax system from its other objectives (e.g. equity, environmental or public health matters). In order to make the assessment of the effects of the tax structure on economic performance manageable, these objectives are not dealt with in great detail in this report, except when there is a clear trade-off between these and tax reforms aimed at raising GDP per capita (Johansson, et al. 2008).

Finally, this report examined the consequences of taxes for both GDP per capita levels and their transitional growth rates, with a large part of the empirical analysis being devoted to assessing the effects of different forms of personal and corporate income taxation on total factor productivity growth (Johansson, et al. 2008). Other premises of the OECD study were as follows:

1. In open economies the design of a national tax system would need to consider the design of tax systems in other countries, since the latter are increasingly using their tax systems to improve their ability to compete in global markets. Globalisation may also increase the opportunities for tax avoidance and evasion, especially as far as mobile capital income tax bases are concerned. Therefore, the mobility of the tax base plays a part in the design of tax reforms at the national level while increased international tax policy cooperation among countries may allow for efficiency gains in some areas.

2. Optimal taxation, or how to minimise the excess burden of taxation, is an important topic that is largely outside the scope of the OECD report. Additionally, tax incidence, or the person or entity which bears the burden of a tax, is not explicitly addressed in this work, except when it has implications for the way the tax structure affects the determinants of growth.
3. The transition costs of tax reform (such as costs to the public administration and costs to businesses in adapting to policy changes) are not considered. These costs imply that tax reform will only be attractive if it can be expected to produce offsetting gains in economic performance.

The key results of the report are discussed in the sections below.

13.1 General international trends in taxes that are relevant for growth

Although it is difficult to generalise, the following trends are salient:

1. Most OECD countries rely on three main sources of tax revenues: personal and corporate income taxes, social security contributions and taxes on goods and services
2. Over the past three decades, revenue shares of PIT have decreased, while the revenue shares of CIT and social security contributions have increased
3. The share of consumption taxes in total revenues has declined, with a move away from taxes on specific goods and services towards a greater use of general consumption taxes (mainly VAT)
4. The share of property taxes and environment-related taxes has been fairly constant over time
5. The most pronounced changes in PIT have been the reduction in the top statutory income tax rates
6. The reduction in the PIT rates has been accompanied by cuts in the CIT rate, partly financed by base broadening in many countries
7. The overall top marginal rate on dividends has decreased mainly as a result of the reduction in the CIT rate
8. Several countries have introduced tax incentives for investment in research and development.

Table 17, below, compares the composition of the South African tax revenue to that of other countries, revealing that it is not altogether clear whether, and to what extent, this resembles the composition of industrial or developing countries' tax revenues.

Table 17: Comparison of central government revenue by type, 2010

Tax type	% contribution to total tax revenue		
	Developing countries	Industrial countries	South Africa
Taxes on income, profits and capital gains	**31.1**	**48.1**	52.4
Payable by individuals	12.7	35.1	20.9
Payable by corporations and other enterprises	18.0	12.6	20.9
Taxes on payroll and workforce	**0.8**	**1.3**	1.2
Taxes on property	**4.1**	**7.1**	5.4
Taxes on goods and services	**55.8**	**41.9**	37.3
General taxes (e.g. value-added taxes)	38.5	26.0	25.3
Excises	13.2	9.8	10.1
Taxes on international trade and transactions	**6.0**	**0.6**	3.7
Total tax revenue as % of GDP	19.9	24.9	26.5
Social contributions as % of GDP	4.7	10.0	0.5

Source: Black, Calitz, & Steenekamp (2015 (forthcoming)).

13.2 Broad policy options for reforming the overall tax mix to enhance growth in OECD countries[9]

The tax policy changes that are most likely to increase growth in any particular country will depend on its initial conditions, in terms of both its current tax system and the areas (such as employment, investment or productivity growth) in which its current economic performance is relatively poor. Reforms should be regarded as small tax changes rather than as shifting the revenue base entirely to one particular tax instrument on the basis that it provides more of a growth bonus, since it is probable that there are diminishing growth returns to adjusting taxes.

The ideal would be to design a tax system that will not discourage taxpayers from formally participating in the economy; indeed, a tax system can have important economic effects such as influencing firms' decisions on whether to operate in the formal sector (World Bank Group & PWC, 2016).

The 2008 OECD report suggested a "tax and growth ranking" with recurrent taxes on immovable property being the *least* distortive tax instrument in terms of reducing long-run GDP per capita, followed by consumption taxes (and other property taxes), personal income taxes and corporate income taxes.[10] Such tax shifts therefore imply a non-trivial trade-off between tax policies that enhance GDP per capita and equity, which is likely to be evaluated differently across OECD countries (Johansson, Heady, Arnold, Brys, & Vartia, 2008; OECD, 2007).

[9] See Johansson, et al. (2008) and OECD (2007).
[10] This implies a considerable trade-off between revenue potential and efficiency.

Across OECD countries, a revenue neutral growth-oriented tax reform would be to shift part of the revenue base from income taxes to less distortive taxes. Taxes on residential property are likely to have the least impact on growth. However, the scope for switching revenue to recurrent taxes on immovable property is limited in most countries, both because these taxes are often currently being levied by sub-national governments (as in the case of South Africa where municipalities have the fiscal power to levy property rates) and, furthermore, because taxes on immovable property are particularly unpopular. Therefore, few countries manage to raise substantial revenues from property taxes.

Practically, greater revenue may be achieved through levying consumption taxes. However, with consumption taxes being less progressive than personal income taxes, or even regressive, a shift in the tax structure from personal income to consumption taxes would reduce progressivity.[11] Similarly, shifting from corporate to consumption taxation is likely to increase share prices (by increasing the after-tax present value of the firm) and wealth inequality, as well as increasing income inequality by lowering capital income taxation.

Most taxes would benefit from a combination of base broadening and rate reduction. For example, broadening the base of consumption taxes is a better way of increasing their revenues than rate increases, because a broad base improves efficiency while a high rate encourages the growth of the shadow economy.

In relation to income taxes, relying less on corporate income relative to personal income taxes could increase efficiency. However, lowering the corporate tax rate substantially below the top PIT rate could jeopardise the integrity of the tax system as high-income individuals would attempt to shelter their savings within corporations, trusts and other legal entities. There is also evidence that flattening the PIT schedule could be beneficial for stimulating GDP per capita, notably by favouring entrepreneurship.[12] Once again, this seems to imply a trade-off[13] between growth and equity in OECD countries (OECD, 2007).

13.3 Possible avenues for tax reforms to enhance the performance of the various drivers of GDP: the case of OECD countries

Tax reforms aimed at enhancing GDP growth in OECD countries have typically focussed on directly stimulating labour absorption, domestic private sector investment and productivity. Each of these approaches is discussed in greater detail below and together constitute the main findings of a paper analysing the effects of changes in tax structures on GDP per capita and its main determinants in OECD countries (Johansson, Heady, Arnold, Brys & Vartia, 2008). A later section examines indirect growth mechanisms, such as foreign direct investment and so forth.

[11] As was argued by the Katz Commission, among others, the distributional effects of taxes such as VAT should be assessed in conjunction with those of targeted public spending programmes.
[12] There is ample evidence on the economic effects of “flat taxes” from the experiments conducted by Russia and other countries.
[13] The extent, of course, depends on the level of the tax threshold and how much of the tax leakage can be arrested by a simpler and lower statutory rate (if one thinks of a flat rate) or rate schedule (if still progressive).

13.3.1 Labour utilisation[14]

Reforms of labour income taxation will generally need to differ, depending on whether the aim is to raise participation or hours worked. Reducing average labour taxes could be desirable for raising participation. On the other hand, lowering marginal rates may be preferable for increasing hours worked. This could affect the effective average and marginal tax rates, particularly for low-skilled workers or second income-earners. Reductions in the marginal tax rate could lead to greater income inequality. The effects of changes in labour taxes on employment are also likely to be dependent on specific labour market institutions, such as wage-setting mechanisms and minimum wages, which affect the passing on of taxes to labour cost.

Reducing the progressivity of the PIT schedule may lead to gains, both in the quantity and the quality of labour supply. Evidence records adverse effects of highly progressive income tax schedules on GDP per capita through both lower labour utilisation and lower productivity, partly reflecting diminished incentives to invest in higher education. This implies a potential trade-off between growth-enhancing tax policies and distributional objectives in OECD countries. However, there may be win-win labour tax reforms in this area. For example, "in-work benefits"[15] increase the income of low-income households, thus reducing inequality, and may also improve efficiency if the gain in labour force participation outweighs the adverse incentives for hours worked by job-holders (as benefits are withdrawn) and for human capital formation (as the returns from up-skilling are reduced), as well as the distortionary costs of the tax increases that are needed to finance the in-work benefits (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

13.3.2 Investment

Reducing corporate tax rates and removing special tax relief can enhance investment in various ways.[16] If the primary aims are to reduce distortions that hold back the level of domestic investment and to attract foreign direct investment (FDI), reducing the corporate tax rate may be preferable to reducing PIT on dividends and capital gains (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

Tax incentives have come under greater scrutiny, given the European Union State Aid guidelines increasingly cracking down on the use of tax competition to attract FDI. More importantly, such as in the case of Ireland, tax incentives can be used as an instrument within a much larger development strategy. For example, grant supports are awarded on a discretionary basis depending on the perceived value of the enterprise to Ireland. Sectoral priorities are identified based on systematic analyses of global growth patterns and the changing degrees of tradability of products and services (Vale Columbia Center, 2013).

[14] This can be viewed as a way in which the tax system can enhance the *inclusivity* of economic growth.

[15] In-work benefits: in-work tax measures to encourage work incentives of marginal workers. In-work benefits, conditional on employment, encourage participation in the labour market and reduce the likelihood of "unemployment" or "inactivity traps" (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

[16] The Irish experience with corporate tax reduction can provide additional insights into this subject. Should such a reform be successful, the ensuing credibility would imply a number of other institutional changes and certainties, such as those of property rights and effective public services.

Evidence suggests that favourable tax treatment of investment in small firms may be ineffective in raising overall investment. Lowering the corporate tax rate and removing differential tax treatment may also improve the quality of investment by reducing possible tax-induced distortions in the choice of assets. Providing greater certainty and predictability in the application of CIT and greater clarity about tax rules may lead to higher investment, which in turn, could enhance growth performance countries (Johansson, Heady, Arnold, Brys, & Vartia, 2008; OECD, 2007).

13.3.3 Productivity

There are several ways in which tax policy can influence productivity. One option is to reduce the top marginal statutory tax rate on personal income since it may have an impact on productivity via entrepreneurship, affecting risk taking by individuals. While empirical research has pointed to conflicting ways in which entrepreneurship could be affected, evidence confirms that a reduction in the top marginal tax rate is found to raise productivity in industries with potentially high rates of enterprise creation. Therefore, reducing such rates may help to enhance economy-wide productivity in OECD countries that have a large share of such industries, although the trade-off with equity objectives needs to be kept in mind.[17] It is also possible that cutting top marginal tax rates could increase economy-wide productivity through composition effects, by increasing the share of industries with high rates of enterprise creation (Johansson, Heady, Arnold, Brys, & Vartia, 2008).

A second option is to reform corporate taxes, as they could influence productivity in several ways. Evidence from the OECD study (2007) suggests that lowering statutory corporate tax rates may lead to particularly large productivity gains in firms that are dynamic and profitable, i.e. those that can make the largest contribution to GDP growth. It also appears that corporate taxes adversely influence productivity in all firms except in newly established and small ones since these are often not very profitable, at least initially. One possible implication is that tax exemptions or reduced statutory corporate tax rates for small firms might be much less effective in raising productivity than a generalised reduction in the overall statutory corporate tax rate. This reduction could be financed by scaling down exemptions granted on firm size as they may only waste resources without any substantial positive growth effects.

In OECD countries, a widely-used policy avenue to improve productivity is to stimulate private-sector innovative activity by providing tax incentives to research and development (R&D) expenditure.[18] This study finds that the effect of these tax incentives on productivity appears to be relatively modest, although it is larger for

[17] The question that arises is whether *each* tax change should pass the equity test, or whether one should rather have *any* of the following passing the test: (a) the composite tax system, which diverts the attention to other taxes; (b) the entire fiscal system, which diverts the attention to the expenditure and regulatory side of government; and (c) the wider economy, which diverts the attention to the performance over time of the entire economy as it responds to efficiency and growth-related policies and structural changes (not necessarily of a tax nature) designed to enhance inclusivity and equity.

[18] However, there might be a risk that one may waste tax incentives on firms in which there is not, in any case, a desire to enhance profitability by increasing productivity. Such incentives may end up supporting tax-driven businesses.

industries that are structurally more R&D intensive.[19] Nonetheless, tax incentives have been found to have a stronger effect on R&D expenditure than direct funding.

Lower corporate and labour taxes may also encourage inbound FDI**,** which has been found to increase productivity of resident firms. In addition, multinational enterprises are attracted by tax systems that are stable and predictable and which are administered in an efficient and transparent manner. Tax reforms have generally been driven by the need to provide a fiscal environment that is more conducive to investment, risk-taking and work incentives, while also improving the fairness, simplicity and transparency of the tax systems (OECD, 2007)**.**

Overall, it needs to be emphasised that policymakers in OECD countries will need to examine the trade-off between these growth-enhancing proposals and other objectives of tax systems – particularly equity – very carefully (Johansson, Heady, Arnold, Brys & Vartia, 2008). It is, however, important to note that in line with the efficiency-equity trade-off, conventional tax theory has played an important role in fostering declining tax rates globally. A 2014 OECD report proposed an alternative theoretical approach. It argues that the rationale behind declining tax rates in the past 40 years was based on models of economic principles where tax rates for top incomes affect growth and investment rates. Evidence suggested that changes in tax rates affect behavioural responses and thus the taxable income. Lower marginal tax rates were deemed to trigger investments, stimulate labour supply and, hence, increase growth. The impact of even the basic tax model is nevertheless uncertain since this depends on the relative impact of two effects: the income effect and the substitution effect (Förster, Llena-Nozal, & Nafilyan, 2014).

Another report from the OECD (2007) confirmed that tax policies can play a major role in the short and longer term for productivity and economic growth. The level and structure of taxes and the public services that they finance, affect all aspects of economic activity. However, the direction of tax effects on the level and growth in GDP is not always straightforward. Taxation may improve living standards if it provides the basis for the provision of public goods that increase social welfare as well as the level and productivity of physical and human capital. On the other hand, higher taxes may increase distortions that reduce savings, investment, participation in the labour market, technological innovation and, ultimately, economic growth. The adverse effects of taxation on growth may rise disproportionately with the increase in the level of taxation, but also depend on the structure of taxation and whether tax revenues are spent productively or not (OECD, 2007).[20]

[19] This suggests that, if need be, it would be preferable rather to design incentives for them on the basis of the positive externalities associated with R&D.

[20] Overall, one must avoid burdening a tax system with too many goals. It complicates the system, confuses issues, and provides gaps for rent-seeking, etc. A relatively simple system seems more useful. The credibility of the tax system is a function of the clarity of (easily-understandable) rules, perceived fairness in design and application, consistency, predictability and efficient use of the proceeds by government (quality of service delivery). These factors may at times be as important as the level of taxes.

This OECD report (2007) focused on the effects of tax systems on economic growth, through:

- Its direct effects on technological progress
- Its indirect effects on factor supply
- The efficiency of the allocation of resources (OECD, 2007).

13.4 The macroeconomic links between taxes and growth in OECD countries[21]

Growth equations were estimated for a sample of 21 OECD countries over the period 1971-2004 (OECD, 2007); the empirical findings indicate that high tax burdens tend to have a negative impact on GDP per capita. This result cannot however be taken as evidence of the impact of the tax system on growth, but rather as signalling that, at least within the OECD sample and over the particular time period, a government of a large size may have long run detrimental effects on GDP per capita.

Government expenditure also displays a negative association with economic growth, if included, in isolation, in the growth equations. However, if such expenditure is considered together with the overall tax variable, the latter becomes statistically insignificant. It comes as no surprise that just one of the overall measures remains significant in this regression, given that the two are essentially flip-sides of the same coin. Controlling for the overall tax burden, there is a negative estimated effect on GDP per capita when a lower proportion of the tax revenue is obtained through indirect taxes. This is consistent with direct taxes having relatively stronger distortionary effects, which in turn may lead to lower long-term GDP per capita.

Controlling for both the overall tax burden and the tax mix between direct and indirect taxes, the preliminary results suggest that the negative long-term growth impact of taxing corporate income exceeds that of taxes on labour income. Accounting for other determinants of economic growth (such as inflation, the variability of inflation, trade exposure and expenditures on research and development), some of which turn out to be highly significant, does not alter the basic conclusions regarding the relationship between taxes and growth.

13.5 The indirect channels through which taxes affect growth

Taxation potentially affects growth indirectly through its effects on factor intensity, quality of labour and capital as well as by stimulating innovation and entrepreneurship. The discussion below describes the findings of an OECD paper analysing the links between tax and growth for a sample of 21 OECD countries over the period 1971-2004 (OECD, 2007):

- ***Effects on labour utilisation and human capital****:* Taxation is found to have a positive effect on unemployment in the OECD. The tax wedge between labour cost and take-home pay (for a single earner couple with two children at average earnings levels) is used as a main indicator of tax burden on labour.

[21] See OECD (2007).

The tax wedge is also found to have a negative and statistically significant effect on employment rates. Taxes have an impact on hours worked over and above their effects on participation. In particular, the marginal tax rates of the second earner are found to be important drivers of hours worked.[22]

- ***Effects on FDI and R&D***:
  Evidence from meta-analysis studies suggests that estimated tax elasticities tend to be higher if average tax rates are used as a measure of tax burden on FDI, rather than statutory or marginal tax rates. A one percentage point increase in effective corporate tax rates reduces FDI stocks by 1-2%. Moving to a system where foreign source income is exempt from taxation in the home country of the parent company is found to increase the outward FDI stock. Recent evidence suggests that, after controlling for other policy factors (e.g. product market regulations, employment protection legislation, measures of economic conditions and science policies and institutions), a permanent decrease in the tax subsidies for R&D, measured by the so called B-index (defined as one minus the rate of tax subsidy for R&D) could raise R&D expenditure and the number of patents by around 5% and less than 2%, respectively.[23] Moreover, tax relief for R&D is found to have stronger and more robust effects on both R&D expenditure and patents than direct subsidies (Johansson, Heady, Arnold, Brys, & Vartia, 2008).[24] In spite of these results in the OECD countries, a central issue on which the OECD is currently focusing is reducing harmful tax competition of all kinds.[25] The EU regulates the use of tax incentives through its sophisticated State Aid laws. Effective tax deductions can rarely substitute for serious shortcomings in the wider business environment, nor should they be used to do so. Recent work by the IFC at the World Bank is decidedly cautious about reducing effective taxes to attract businesses owing to the substantial costs involved (James, 2013).

13.6 The links between taxes and growth at the industry and firm level

The OECD report (2007), which analysed the links between tax and growth for a sample of 21 OECD countries, showed that productivity and growth performance vary significantly across industries and, within each of them, across individual firms. In particular, over the past two decades, specific industries, e.g. Information and Communication Technology (ICT)-producing and ICT-using industries, and specific types of firms have played a major role in driving aggregate growth, promoting innovation and the adoption of new technologies. Differences among industries and

[22] It would be useful to know where the tipping point is located on the income scale, i.e., where for example, the income effect of a tax increase, which would be an inducement to work more, becomes smaller than the substitution effect (which induces less work because of the high opportunity cost of leisure foregone).

[23] The applicability of these results to a single country with low initial R&D, however, could be questioned, despite the cross-sectional nature of the OECD study.

[24] See "Why tax incentives may be an ineffective tool to encouraging investment? the role of investment climate" http://tax.network/svanparys/why-tax-incentives-may-ineffective-tool-encouraging-investment-the-role-investment-climate, accessed 29 February 2016

[25] See "EU Harmful Tax competition": http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm, accessed 29 February 2016.

firms are partly due to market and technological factors. However, a huge number of policy and institutional factors, including the tax system, influence the business environment conditions in which specific industries and firms operate.

Taxes affect the private returns of almost all economic decisions regarding the choice of activity, factor inputs, investment and technology. In the absence of taxes, these choices would maximise economic benefits, while taxation may distort economic decisions so as to maximise after-tax returns instead.[26]

- *Taxes on corporate income*: They distort the returns on capital and the magnitude of their impact is often felt unevenly across different types of businesses or sectors.
- *Taxes on the use of labour inputs may distort the optimal allocation of factors of production:* Moreover, the distortionary effect on labour allocation may also pertain to labour quality and skill composition. For example, a tax system may grant implicit subsidies for the employment of low-skilled labour by reducing employers' social security contributions for low-wage employees. If this generates a shift towards an increased demand for low-skilled labour, overall labour productivity is expected to decrease. A similar demand shift may occur under excessive progressivity of taxes on labour, to the extent that workers can pass part of the progressivity effect through to employers.
- *Some aspects of the tax structure may even have a simultaneous effect on the productivity growth of all factors*. Whenever taxes on single production inputs discourage the use of a production factor more than others, businesses will attempt to substitute away from that factor by using others more intensively.

13.6.1 Industry-level analysis

Higher corporate taxes tend to depress MFP (multi-factor productivity) growth, especially in those industries where the tax base tends to be large and where there is greater potential to re-invest resources in productivity-enhancing activities. Preliminary results do not provide solid evidence on the effect of the overall tax burden on MFP growth in more labour-intensive industries, but offer an indication of a possible significant effect on social security contributions on these industries (OECD, 2007).

13.6.2 Firm-level analysis

Aggregate productivity and growth are also determined to a large extent by how efficiently resources are allocated across businesses within a given sector.

The firm-level analysis will shed light on how different elements of the tax structure facilitate or hamper aggregate output growth, investment and productivity growth through a re-allocation of resources towards (or away from) their most productive uses. In doing so, this analysis will complement and further support the empirical results obtained with the industry-level analysis (OECD, 2007).

[26] This is why an allocatively efficient tax is viewed as one that is neutral towards the choice between alternatives.

A 2012 OECD report developed a new model for projecting growth of OECD and major non-OECD economies over the next 50 years as well as imbalances that might arise. In that model, a baseline scenario, assuming gradual structural reform (in labour and product markets) and fiscal consolidation to stabilise government-debt-to GDP ratios, is compared with variant scenarios assuming more ambitious policies. According to this report, once the aftermath of the global financial crisis has been overcome, global GDP could grow at around 3% per year over the next 50 years. This growth will be enabled by continued fiscal and structural reforms and sustained by the rising share, of relatively fast-growing emerging countries, in global output (OECD, 2012).

However, despite this fast growth in low-income and emerging countries, large cross-country differences in living standards will persist in 2060. Income per capita in the poorest economies will more than quadruple by 2060 while China and India will experience more than a seven-fold increase, but living standards in these countries and some other emerging countries will still only be one-quarter to 60% of the level in the leading countries in 2060. Nevertheless, bolder structural reforms and more ambitious fiscal policy (e.g. policies that induce convergence towards best practice labour force participation) could raise long-run living standards by an average of 16% relative to the baseline scenario of moderate policy improvements. Ambitious product market reforms, which raise productivity growth, could increase global GDP by an average of about 10%. Policies that induce convergence towards best practice labour force participation could increase GDP by close to 6% on average (OECD, 2012).

According to Geiger, Kermode and Owens (2013), overall, tax policy could help to create a strong basis for the expansion of productive investment and competitive enterprises. For that purpose tax systems need to be effective in terms of revenue generation, integrated with strategies to stimulate sustainable growth and fairness in the distribution of the tax burden. However, tax law in all countries has not kept pace with the international business environment. The diversity of national tax systems and the weakness of international cooperation may lead either to economic double taxation or double non-taxation. The national tax base of countries in which companies operate could be eroded through complex schemes of transfer pricing, abuse of tax havens and abusive tax avoidance strategies.

Tax aims at several objectives which need to be carefully balanced in order to achieve coherent results: tax revenues are key to the budgetary stability and fiscal consolidation which are needed for moving out of the current crisis. But taxpayers also expect that their contribution is used to enhance public investment and services which are necessary to prepare the ground for sustainable growth and increased competitiveness. In addition, they demand that the tax burden is fairly allocated. The authors just cited argued that tax and expenditure policies, taken together, can do much to reduce income inequalities, which have increased during the last decades.

Non-tax policies, such as upgrading of human skills and providing decent job opportunities, are important for reducing inequality, but tax policies can assist as well: for example, through a well-balanced tax mix, through progressive tax rates for high incomes, eliminating tax privileges which mainly benefit those in higher income brackets and reforming social contribution systems. There is also a role for taxes on

property and wealth in reducing inequalities at the high end of the income scale. Specifically, taxation must be increasingly viewed as an instrument for enhancing social cohesion and political stability. As such, it is necessary to examine the case for reducing inequalities including policies such as tax measures relating to net wealth, inheritance taxes, land and buildings (Geiger, Kermode, & Owens, 2013).

The key challenges addressed in the 2013 IMF report (IMF, 2013a) "*Taxing Times*" are the following: *how can taxation best help bring down debt ratios in advanced economies and respond to mounting spending needs in developing countries? How can equity concerns be balanced, especially in hard times, with the efficiency that is needed to secure long-term growth*? In answering the question of whether countries can tax more, better and more fairly, results have established that the scope to raise more revenue is limited in many advanced economies and, where tax ratios are already high, the bulk of adjustment will have to fall on spending. Nonetheless, many (including some with the largest consolidation needs, such as the United States and Japan) could still mobilise significant amounts while limiting distortions and adverse effects on growth.

Broadening the base of the VAT ranks high in terms of economic efficiency and can in most cases easily be combined with adequate protection for the poor. In emerging market economies and low-income countries, where the potential for raising revenue is often substantial, improving compliance remains a central challenge. Although the amount is difficult to quantify, significant revenue can also be gained from reforming it. This is particularly important for developing countries, given their greater reliance on corporate taxation, with revenue from this taxation often coming from a handful of MNEs. There is a strong case in most countries, advanced or developing, for raising substantially more from property taxes; nevertheless, this is best done when property markets are reasonably resilient. In principle, taxes on wealth also offer significant revenue potential at relatively low efficiency costs. Their past performance is far from encouraging, but this could change as increased public interest and stepped-up international cooperation build support and reduce evasion opportunities (IMF, 2013a).

13.7 Tax design for inclusive and sustainable economic growth in OECD countries

In the context of growing inequality amid rising prosperity, a 2013 OECD report examined the role of taxation in promoting "inclusive" growth. It discussed the issues of how "inclusive and sustainable economic growth" should be defined, how the design of tax systems (PIT, social security contributions (SSCs), VAT, environmental taxes and property taxes) could be improved to redistribute income and wealth as efficiently and effectively as possible, as well as the development of an all-inclusive tax progressivity. The concept of inclusive growth is related to long-held notions of exploiting synergies and managing trade-offs between efficiency and equity. It also places more emphasis on a more dynamic definition of equity and the importance of a fairer distribution of opportunities to participate in the labour market, use skills and contribute to society (OECD, 2013b).

13.7.1 Defining "inclusive and sustainable" economic growth

There has been extensive debate on the definition of "inclusive growth", which for many means economic growth that combines increased prosperity and equity. Some of the approaches focus on productive employment, so that economic growth can generate the jobs needed, meet the demands of the private sector for skills and competencies and ensure that workers reap the benefits of rising productivity. Other approaches emphasise options for making growth pro-poor, in a manner that delivers higher income gains for the poor than for the rest of the population and that, in doing so, helps to reduce growing inequalities in living standards. There are still other approaches that focus not only on the economic but also on the non-economic opportunities generated by economic growth and on sharing the benefits of growth in terms of the quality of jobs, the health and education status of the population and/ or the skills of the labour force. According to some authors, inclusive growth "looks to ensure broadly shared opportunities: not only the opportunities to accumulate a wide range of income-enhancing assets, but the opportunities to fully utilise and benefit from these assets in productive activities" (OECD, 2013b).

According to the report, "Inclusive and sustainable economic growth" consists of four dimensions:

- Fair opportunities to participate for all
- An efficient use of all resources
- A fair remuneration for participants
- Sustainability of their contributions.

These dimensions set the conditions that lead to inclusive and sustainable economic growth. If each individual is perceived as the cornerstone of economic development, "inclusive and sustainable economic growth" implies [that] "Individuals, independent of their socio-economic background, gender, place of residence or ethnic origin, face fair opportunities to participate in and contribute to economic activities" (OECD, 2013b).

13.7.2 How can the design of tax systems be improved to support "inclusive and sustainable" economic growth?

On average across the OECD, transfers and taxes reduce inequality considerably. However, the redistributive impact of the tax and transfer system on inequality and poverty has decreased in many countries during the past ten years and has consequently not countered the strong increases in market income inequality (OECD, 2013b).

Current ongoing fiscal consolidation efforts in many OECD countries, aimed at bringing down Government debt to sustainable levels, as well as increasing spending pressures (especially on pension and health) as a result of ageing populations, may reduce the scope for transfer policies to lower inequality. As a result, it may be necessary for governments to focus on the tax system and enhance their role in redistributing more income, from the richer to the poorer.

- Opportunities for increasing the overall progressivity of the tax system may be limited if taxes are already high

- Countries could reduce inequality by removing opportunities for tax avoidance and evasion, which typically benefit higher-income groups. Such a strategy will improve both the efficiency and the distributional impact of the tax system
- Cutting and/or improving the design of tax expenditures may also increase efficiency, as it would reduce distortions in resource allocation, and improve equity, as in many cases the richer tend to benefit the most from tax expenditures
- Improving the design of the VAT and possibly of environmental taxes may help as well
- There is possibly also a greater role to play for progressive property taxes and especially recurrent taxes on immovable property and inheritance/ estate and gift taxes
- Policies that address the causes of growing inequality could also be implemented more efficiently, for example, by making more use of in-work benefits which encourage people to take up work and give additional income support to low-income households
- The most progressive social benefits could be protected and other benefits could be targeted better, to reach especially those with lower incomes
- Another important policy challenge is to improve equal access and quality of education and training which will enable workers to take up better-paid jobs and thus reduce inequality. The tax system might play a role here as well (OECD, 2013b).

Overall, the report discusses how the design of the PIT, SSCs, the VAT, environmental taxes and property taxes can be improved in such ways that the tax system supports "inclusive and sustainable" economic growth. It points to some of the most important policy concerns and challenges and discusses when trade-offs might have to be made between pro-growth tax reform and equity concerns. Specifically, the report raises issues in relation to direct taxes paid by individuals and focuses on the distributional impact and challenges of the VAT as well as the taxation of (residential) immovable property (OECD, 2013b).

In the case of South Africa, the intractability of poverty and inequality and the pervasive effect they have on the country's ability to attain many developmental outcomes, may justify a greater degree of redistribution through the tax side of the budget. In fact, careful tax design can achieve greater tax equity without sacrificing either total tax revenue or future investment. This approach is slowly gaining traction within the mainstream tax discourse. As the OECD's chief economist and Deputy-Secretary General, Pier Carlo Padoan, noted: "Tax hikes that can bolster equality and have relatively little impact on long-term growth, such as on real estate, should be considered....Meanwhile, hikes in capital income taxes would be positive for equity and would not necessarily distort growth, while shifting tax burdens away from labour and towards green consumption taxes, for instance, would also bring benefits."[27]

[27] See "How to get it right: government balances, growth and income inequality" at: http://www.oecd.org/forum/government-balances-growth-and-income-inequality.htm, accessed 29 February 2016.

14 ASSESSING THE SOUTH AFRICAN TAX SYSTEM AGAINST GOOD PRACTICE CRITERIA IN TAX DESIGN

This section aims to assess the current South African tax system against the criteria for a good tax system articulated in Section 5 above. It focuses particularly on the role of the said system in supporting inclusive growth, employment, development, equity and fiscal sustainability in South Africa and on how it might be best structured to achieve these objectives.

The advantages of assessing the extent to which the South African tax system conforms to the characteristics of a good tax system are manifold: This high level assessment will assist in designing strategic tax reforms whose cumulative effects on the evolution of the tax structure as *a whole* have been considered; it will ensure that conflicting objectives are not pursued at random and that particular objectives are not pursued in contradictory ways (Mirrlees, et al., 2011). The assessment focusses first on the major individual tax handles (PIT, CIT, VAT and customs duty) in relation to their efficiency (both economic and administrative), equity, transparency and flexibility/buoyancy. It concludes with observations on the tax system as a whole.

14.1 Personal income tax

14.1.1 Efficiency (economic and administrative)

The theoretical literature presents the perspective that a general tax on income such as a head or a poll tax or a tax on the entire income base (excluding leisure) is efficient (i.e. has no excess burden) since relative prices remain unchanged and therefore behaviours are not modified as a response to tax. Given that leisure can be ignored or taxed, the PIT becomes a selective tax on labour income which does have an excess burden. Specifically, people may well decide to work more or less as a result of the PIT, thus affecting the supply of labour, with the ultimate effect being determined by the attendant income and substitution effects (Gruber, 2009; Black, Calitz, & Steenekamp, 2011). In South Africa, empirical evidence suggests that labour supply appears to be inelastic to tax decisions despite such decisions controlling for other hidden costs, such as transport and grant pay-outs. The results further suggest that it may be possible to raise the lower marginal tax rates and the top rates while reducing those in the middle of the tax schedule (Jooste, 2013).

Additionally, a PIT levied on interest income will be economically inefficient as it changes the relative price of present consumption in terms of future consumption and consequently causes individuals to substitute between present and future consumption. Besides impacting on the supply of labour, the PIT applied selectively on interest income also results in income and substitution effects which together may cause the amount of private savings to increase or decrease. This is particularly important in the context of South Africa where savings as a percentage of household disposable income have declined from 4.1% in 1993 to -0.1% in 2008 (Black, Calitz, & Steenekamp, 2011). Overall, the international empirical results of the effect of PIT on savings are inconclusive; ranging from a low interest elasticity with respect to savings, to other conclusions.

With regard to administrative efficiency, income taxes are, in general, complex so that minimising administrative and compliance costs would require relatively sophisticated taxpayers and tax administrators. To achieve administrative efficiency,

as previously noted SARS has introduced an electronic filing facility (Black, Calitz, & Steenekamp, 2011).

14.1.2 Equity, fairness

The PIT system promotes the ability-to pay principle in that the system of exemptions, deductions, rebates and marginal tax rates requires people with equal capacity to pay the same amount of tax and for people with greater capacity to pay more. The incidence of taxation on producers and consumers is ultimately determined by the elasticities of supply and demand. Empirical evidence in South Africa and elsewhere indicates a relatively inelastic supply of labour for men, meaning that they tend to bear the burden of the tax. In the case of married women and high-income professionals who are internationally mobile, the supply of labour is relatively less inelastic, which means that the employer and employee will share the burden of the tax (Gruber, 2009; Black, Calitz, & Steenekamp, 2011).

Overall, according to the NDP, the PIT is a progressive form of raising revenue as the level of income determines the amount of the tax, so that the poorest are not taxed (NDP 2012: 344).

PIT has a progressive structure (i.e. those with higher earnings are liable to pay higher tax). Earnings are levied at a minimum marginal rate of 18% to a maximum rate of 40%, thus helping address some of the economic imbalances in South African society. The system also contains primary, secondary and tertiary rebates which are used to determine the tax thresholds below which individuals below the age of 65, and between 65 and 75 and above 75, are exempted from tax. Since 2007, the effective tax rate, indicated by PIT collections as the percentage of its tax base, has remained stable between 17.5 and 19.5%, thus indicating the effectiveness of tax relief, in particular fiscal drag, in maintaining income equality and keeping progressivity stable.[28]

The PIT can be designed to achieve the desired degree of progressivity while other aspects of the tax system can be focused on achieving efficiency. Overall, the fairness and progressivity of the PIT system is dependent on how quickly the income tax brackets increase as taxable income rises, as well as the level of taxable income at which individuals start to pay tax, i.e. the tax-free threshold.

14.1.3 Transparency and certainty

The manner in which taxes are collected and the calculation of tax liabilities should be certain. Tax rules and procedures should be transparent (National Treasury, 2012).

As mentioned in previous sections, the simplification of the PIT system and the introduction of e-filing has made the system admirably transparent and simple as regards compliance. The threshold for submitting an income tax return has recently been raised again (to R250 000) for employees with a single employer, meaning that the vast majority of workers do not need to file a tax return.

[28] Presentation by the National Treasury to the Macro Analysis sub-committee of the DTC, 29 August 2013.

Transparency would also be enhanced if bracket creep, a concealed way of increasing tax revenue whereby taxpayers are pushed into higher income tax brackets as their nominal income increases, is kept in check. SARS has tempered the effects of bracket creep through regular adjustments of the brackets and rebates on an ad hoc basis (Black, Calitz, & Steenekamp, 2011).

14.1.4 Flexibility/buoyancy

While the tax system should raise sufficient revenue during all phases of the business cycle, it should also lend support to a counter-cyclical fiscal framework (National Treasury, 2012). The PIT is an automatic stabiliser due to its built-in flexibility where countercyclical economic behaviour exists. According to SARS, the PIT is the least volatile tax amongst the main tax handles and correlates strongly with compensation of employees. Furthermore, estimated linear elasticities in South Africa imply that a 1% expansion in the economic cycle increases PIT by 1.43%. However, estimated nonlinear elasticities indicate that, during an expansion, the above elasticities increase by 1.89% whereas during a contraction phase these elasticities increase by 0.89%. These results indicate that low tax collections during economic contractions influence the fiscal sustainability and overall fiscal prudence in South Africa. The findings of high tax elasticities during expansions might explain the underestimation of revenue by the Government (Jooste & Naraidoo, 2011).

14.2 Corporate income tax

Given that South Africa is a small open economy, it faces stringent international tax competition and challenges to protect its tax base as a result of base erosion and profit shifting.

14.2.1 Efficiency (economic and administrative)

Owing to increased globalisation, to the extent that the CIT regime lowers the after-tax return on investments in a country or a region, the country's competitiveness as an investment destination could be eroded, leading to lower levels of FDI and innovation as well as growth. Increasingly mobile capital flows and international tax competition have led many countries to limit increases on CIT rates, but preserve their revenue yields by base broadening.

The various dimensions of investment decisions are differentially influenced by average effective rates, marginal effective rates and other dimensions of the tax system. When making the discrete choice of investment location, the average tax rate for a given stream of pre-tax income is critical since it reflects the share of pre-tax income paid in tax. However, the decision on how much to scale up investment in a given location typically equates the marginal product of capital with its marginal cost. The marginal tax rate influences the marginal cost of capital. International tax competition, however, might constrain not only the statutory rate, but also effective and marginal rates. This has implications in practice for the design of a tax policy to optimise efficiency:

> If there were a specific revenue requirement, and an upper limit on the statutory tax rate, for example, the revenue might be achieved only by broadening the tax base — which in turn implies increasing the marginal tax rate and hence distorting investment decisions. This creates a trade-off in competition for capital and competition for profit, although governments can in

principle use the two tax instruments of the rate and base to compete for both simultaneously (Mirrlees, 2010: 857).

In South Africa there are a number of estimations of average and marginal effective tax rates by sector, as noted in earlier sections of this document. Much less, though, is known about corporate behavioural responses in respect of changes to tax policy parameters in the various sectors and sub-sectors.

The collection of CIT is, generally speaking, administratively efficient, especially as e-filing has become more institutionalised. Nevertheless, there is a priori evidence which suggests that CIT is economically inefficient; it is non-neutral in the sense that it may induce taxpayers to alter their behaviours in ways unrelated to underlying economic fundamentals (the relative costs of production, access to markets and sound infrastructure) solely as a result of the tax system, and also might not minimise the deadweight welfare losses as a result of distorting the underlying allocation of resources in the economy to given revenue adequacy objectives.

Some opportunities to enhance efficiency relate to:

1. *A bias towards debt-financing over equity*: Debt and equity are treated asymmetrically by the tax system: dividends paid from equity capital are not allowed as deductible expenses whilst interest payments are. This asymmetrical tax treatment, which favours debt financing, introduces a distortion into the capital structure of the firm and may encourage retained earnings rather than disbursement of dividends. These issues will be dealt with largely within the BEPS subcommittee of the DTC
2. *Possible misalignment between industrial tax policy and tax policy:* The sectors which Government has prioritised for industrial policy support (e.g. vehicles, metal products and clothing) actually have the highest ETRs. Furthermore, given Government's emphasis on inclusive growth, it is important to ascertain whether accelerated capital depreciation allowances and other incentives do not create a bias towards capital intensive, rather than labour intensive, production methods
3. *Base erosion and profit shifting:* Due to increased globalisation, if South Africa has a CIT rate higher than other similar countries, then the tax base could be undermined by tax practices such as "thin capitalisation" (where multinational enterprises finance as much of their South African activities as possible through debt rather than equity) or through transfer pricing (where South African entities pay prices which are as high as possible and charge prices that as low as possible on transactions with associated companies overseas). South African tax rates tend to be high for developing countries, but low in relation to developed countries (Steenekamp, 2007). A separate report by the DTC will consider measures to counter aggressive tax planning practices
4. *Proliferation of tax incentives:* As outlined in Annexure 2 of this report, there has been an increase in tax incentives. However, it is not certain whether the current exemptions and deductions are having the desired effect, whether their size is appropriate relative to other jurisdictions and so on. Evidence to date has been mixed. A recent impact study, for example, was commissioned by the National Treasury to ascertain the economic and social impact, the cost effectiveness and the costs and benefits of the Urban Development Zones (UDZ) tax incentive. This has taken the form of an accelerated

depreciation allowance applicable to the value of new buildings, improvements to existing buildings and low cost housing since 2007, estimated at R3.2 billion over seven years since 2003 when it was introduced. The study concludes that there was a beneficial leverage effect since "allowable deductions and resulting tax foregone (amongst other factors) leveraged capital investment to the value of approximately R14.4 billion" (DEMACON, 2013). However, other evidence suggests that tax incentives may not be efficient. Using multiplier analysis, Calitz et al. (2013) compare a general reduction in CIT rates, financed by the abolition of specific tax incentives, with the status quo. They conclude that the "impact of such a change induced by an overall corporate tax decrease is an increase in output of R56 017 million, which yields a benefit (net increase in output) to cost (total cost of incentive) ratio of 3.6. This is much larger than any of the targeted incentives listed above" (Calitz, Wallace, & Burrows, 2013, 21)

5. *Arbitrage opportunities due to divergences between the top PIT and CIT rates:* This creates an incentive for high net worth individuals to divert their income. There are a number of methods of escaping higher marginal and effective marginal tax rates by means of lower-taxed companies or trusts. For example, by earning income via a company, which enables income to be taxed at the lower company rate so long as profits are retained within the company. While income may eventually be taxed at the shareholder's marginal rate when this income is eventually distributed as dividends, substantial benefits from tax deferral may accrue if income is retained for a number of years in a company. The reduction in tax liability could be permanent if the dividends are retained in a trust through which a lower rate is paid.

Some of the BEPS reforms in progress in relation to the asymmetrical treatment of debt and equity include:

1. *Artificial debt*: Some debt instruments will be re-characterised as shares (along with the underlying yield) if they contain certain features. Government's main concern is with so-called debt instruments that do not have a realistic possibility of being repaid in 30 years or debt that is convertible into shares at the request of the issuer. Banks and insurers will be excluded from this re-characterisation
2. *Connected person debt*: Excessive debt issued to connected person creditors is of concern if the creditor is exempt from tax on the interest, because connected persons can often use debt and equity interchangeably without serious economic consequence. Limits will be imposed so that the interest on this form of debt does not exceed 40% of earnings after interest on other debts is taken into account. Excess interest will be allowed to roll over for up to five years
3. *Acquisition debt:* In corporate restructuring, use of acquisition debt against future earnings effectively eliminates taxable profits for years to come (with the debt often renewed via a new acquisition in later years). Interest on excessive debt will be allowed to roll over for up to five years. This system will replace the discretionary system applied to interest on discretionary debt

4. *Hybrid debt instruments*: instruments labelled as debt in South Africa (tax deductible payments) and labelled as equity in the other jurisdictions, creating cross-border arbitrage benefits. A two part approach is taken: (a) Re-characterising certain debt instruments as equity, resulting in the "debt principal" being treated as the underlying shares, and the "interest" yield being deemed to be a distribution thereon (dividends or capital distributions); (b) Certain "interest" yields will be treated as dividends. A new set of revised hybrid rules adjusting the 2012 proposed hybrid rules has been proposed; these mainly target:
    - non-redeemable debt
    - debt that is convertible to shares at the instance of the company issuer
    - debt with non-interest related yields
    - debt with repayment terms or yields conditional on the solvency of the company issuer.

14.2.2 Equity and fairness

The tax incidence of CIT is not easy to determine since businesses which bear the legal incidence of the tax may shift the economic incidence forward onto consumers or backwards onto labour or shareholders, or some combination of these. An empirical estimation of behavioural responses to changes in corporate tax parameters is thus vital, but little is known in this regard. A tax incidence study in 2005 attempted to estimate the incidence of CIT under a range of assumptions: where the burden of the tax is shifted (a) onto labour; (b) backwards onto shareholders, both individual and institutional such as pension funds, and (c) forward onto consumers. The study concluded that the greatest share of corporate tax is borne by the top decile and that, as a result, CIT incidence was reasonably progressive, especially in relation to individual shareholders. To the extent that participants in institutional investment, such as pension funds, are more evenly distributed across household deciles and because some of the incidence is shifted onto consumers, there is an element of regressivity (Woolard, Simkins, & Oosthuizen, 2005).

14.2.3 Transparency and certainty

The increasing complexity of corporate tax legislation (often influenced by international developments) has rendered the system more open to interpretation, less certain and less transparent.

14.2.4 Flexibility/buoyancy

While CIT is a significant revenue source, it is also highly cyclical. Recent research on tax elasticities suggests that taxes behave asymmetrically and nonlinearly during expansions and contractions of the business cycle. During an expansion, the CIT elasticity increased by 2.76 per cent (compared to 1.89 per cent for PIT and 2.17 per cent for VAT). During contractions, however, CIT elasticities increased only by 0.88 per cent (compared to 0.89 per cent for PIT and 0.82 per cent for VAT) This may account for a tendency to under-estimate revenue collections during upturns and has implications for achieving structural deficit and revenue collection targets during economic downturns (Jooste & Naraidoo, 2011).

14.2.5 Mining taxation

The evaluation findings of the mining sector CIT are broadly similar to other sectors and are therefore not dealt with separately. The mining industry is, however, a highly regulated one and is also subject to a mining royalty regime (as discussed earlier in this document), which does not comprise taxes but resource rents. Furthermore, ascertaining its economic incidence is more complex due to the large proportion of foreign and institutional shareholders in complex corporate structures. The royalty and other tax dimensions of the mining sector have been dealt with in a separate report by the DTC.

In addition to the issue of tax deductions and exemptions which accrue to the sector as discussed above and which are reflected in Annexure 2 of the document, the following issues, directly related to CIT, merit consideration:

- *The continued relevance of the gold mining formula*: Given that gold mining is a declining industry, it may be worth reviewing whether the favourable tax treatment accorded to gold and uranium mining is still justified.
- *Mining capital expenditure deductions* are difficult to determine as the CIT return does not cater for entities engaged in mining activities. Taxpayers usually reflect these deductions either under wear and tear and/or under other deductions. These deductions need further research in order to determine the appropriateness both of the design of the exemptions and deductions regime and its administration.
- *Mining Dewatering Association*: Although the tax system contains an exemption for mining rehabilitation entities, a comparable exemption does not exist for a mining dewatering association, which restores water levels adversely impacted by mining. This association is funded by several mining houses in a manner similar to a mining rehabilitation fund. The exemption of this association is under consideration.

The Mining Subcommittee has released a separate report on the mining tax and royalty regime in which some of these issues were considered in much greater depth.

14.3 Value added tax

14.3.1 Efficiency (economic and administrative)

VAT was introduced in South Africa in September 1991. It replaced General Sales Tax (GST) which was imposed on the sale of a limited number of goods and services to consumers and on capital and intermediate goods acquired by businesses. The South African VAT system is a good example of a modern VAT (in the tradition of countries such as New Zealand). It may be viewed as a consumption tax because the consumer pays it at the final stage of production. Unlike other indirect taxes and except where VAT-exemption applies (for instance in the cases of transport and

education), it eliminates the cascading effects of taxes on intermediate inputs and therefore does not distort the prices of inputs.[29]

The efficiency cost of taxes arises from their effect on relative prices; the size of this effect is directly related to the tax rate. The distortionary effect of taxes generally increases proportionally to the square of the tax rate. From an efficiency perspective, it is therefore better to raise revenue by imposing a single rate on a broad base rather than by dividing that base into segments and imposing differential rates on each segment. In South Africa, most goods are subject to the same standard rate of 14%. This implies that consumer choices are not influenced by differential tax rates, thereby enhancing efficiency and neutrality. Having a single uniform rate also reduces the administrative and compliance costs of the tax system and avoids legal wrangling over the classification of goods.

While having a single uniform rate which applies to all consumption is optimal from an efficiency point of view, no country in the world operates such a system. International comparisons suggest that South Africa has a relatively limited set of well-motivated zero-ratings, which would thus rank as an extremely efficient system.

Certain foodstuffs are zero-rated in order to advance equity considerations (discussed further below). Other goods, such as diesel and petrol, are zero-rated as they are instead subject to excise duties. A small number of goods (notably public transport and education) are VAT-exempt because they are regarded as merit goods. Finally, some goods are exempt because they are difficult to tax, e.g. financial services. Zero-ratings and VAT exemptions shrink the tax base and require a higher standard rate in order to compensate for the revenue loss. For the 2011/12 fiscal year, zero rated supplies reduced revenue by R41 billion while exempt supplies reduced revenue by another R1 billion (National Treasury, 2014).

VAT exemptions are considered to be an “aberration in terms of the basic logic of VAT” (Ebrill, 2001). Exemptions violate the core principle of VAT as a tax on (all) consumption, and also undermine the efficiency and neutrality of the tax (Bird, 2007). In European countries, where VAT was first introduced, exemptions constitute a very sizeable portion of the potential tax base. By comparison, South Africa compares extremely favourably, with a very limited number of exemptions; notably, certain forms of passenger transport and educational services. Passenger transport by road and rail is exempt for two reasons. Firstly, when VAT was introduced there were concerns that increased bus and train fares would burden the poor. Secondly, it was considered unfeasible to insist that mini-bus taxi operators register as VAT vendors. In the case of educational services, there is a blanket exemption which includes private schools, colleges and universities. Concessions for education are common to most VAT systems, justified on merit grounds. Nevertheless, it could be argued that only Basic Education should be exempt (National Treasury, 2007). This issue requires further investigation.

From the standpoint of economic efficiency, all firms should ideally be included in the VAT system so as to minimise distortions of competitive behaviour. However, there

[29] Diamond & Mirrlees (1971) demonstrate that in order to ensure that production efficiency is attained, inputs should not be taxed, so that all taxes should fall on final consumption goods.

is a trade-off between this and the administrative advantages of excluding small traders from whom little revenue could be raised. In South Africa, small firms are excluded from the VAT system in order to reduce the administrative burden, both on these small firms and on the revenue authorities. The registration threshold is currently set at a turnover level of R1 million. The DTC VAT sub-committee should seek more information as to whether this is the right threshold. In order to answer this question, the compliance costs to small vendors as well as the administrative cost to SARS would need to be established. This threshold should be revisited regularly as inflation effectively reduces the threshold over time.

The South African VAT system follows the destination principle, i.e. exports are zero-rated and imports are subject to VAT. Accordingly, the total tax paid in relation to the supply of goods or services is determined by the rules applicable in the jurisdiction where the supply is consumed; as a result, all revenue accrues to the jurisdiction where the supply to the final consumer occurs. The destination principle offers the advantage that it does not affect the competitiveness of exports. There is widespread consensus that the destination principle, with revenue accruing to the country of import where final consumption occurs, is preferable to the origin principle from both a theoretical and practical standpoint. The destination principle is the international norm and is sanctioned by World Trade Organization rules.

14.3.2 Equity, fairness

Having one uniform rate enhances horizontal equity since individuals with similar expenditure levels will pay the same amount of tax, regardless of their tastes (i.e. how much they spend on particular items).

However, VAT is not vertically equitable. It is widely acknowledged that the poor have a higher average propensity to consume than the rich; i.e. the poor tend to consume everything that they earn while the rich are able to save a portion of their income. Consequently, a broad-based VAT system with a single rate will tend to be regressive (where regressivity/progressivity is measured relative to income).

National Treasury (2007) demonstrates that the zero-rating of specific food stuffs provides a larger *proportional* benefit to the poor (i.e. regressivity is reduced), but provides a larger *absolute* benefit to the rich (who consume larger quantities). It could be argued that the poor would be better served by the elimination of zero-ratings if the additional revenue realised were used to increase pro-poor spending on the expenditure side of the budget.

Inchauste et al. (2015) find that the current VAT regime in South Africa is slightly progressive. They note that if the zero-rating of basic food were replaced with the standard rate, VAT would be regressive, with taxpayers in the bottom 60% of the distribution paying a higher share of VAT than their share in disposable income.

The destination principle is perceived to be a fair practice because domestically produced and imported goods are treated in the same way.

14.3.3 Transparency and certainty

VAT is a highly transparent tax since all invoices must show the amount of VAT included in the sale price. The VAT system entails a trail of invoices that helps improve tax compliance and enforcement. The VAT is, in principle, described as

"self-enforcing" because a taxable business can claim for the refund of the input VAT only if the claim is supported by purchase invoices. This mechanism provides strong incentives for firms to keep invoices of their transactions and is an efficient means for tax authorities to check and cross-check for the purpose of enhancing enforcement.

It is important to note that firms which do not register as VAT vendors (either because they are evading tax or because they fall below the threshold for registration) nevertheless pay VAT. While these traders will not pay over VAT on their sales, they will pay VAT on both their imports and their purchases from VAT-compliant firms. The VAT in such cases functions as an unrecovered input tax.

14.3.4 Flexibility/buoyancy

VAT is a stable and broad-based source of tax revenue and is an efficient method of collecting a large and buoyant revenue for Government.

14.4 Customs duty

14.4.1 Efficiency (economic and administrative)

Customs duties (also known as import tariffs) have been progressively reduced as part of an overall strategy of trade liberalisation in post-Apartheid South Africa. Theory suggests that the relationship between import liberalisation and tariff revenue is ambiguous. Similarly, empirical studies also indicate that there is no clear link between import liberalisation and tariff revenue (Edwards & Dunne, 2006).

When imported goods are subject to higher taxes than domestically produced goods this reduces efficiency as domestic producers are not fully subject to competitive pressure, leading to an inefficient allocation of resources. As a result of its participation in the GATT Uruguay Round, South Africa has significantly reduced its number of tariff lines and bound most to binding WTO levels. It has cut back tariff lines from about eighty different levels in the early 1990s to eight levels ranging from zero to 30% with a few exceptions, notably in the clothing and textile and motor industry sectors. The general trend has been for tariffs to be reduced to encourage industries to become more competitive and to reduce cost structures too.

However, further progress could be made. High nominal and effective protection remains in sectors such as clothing, textiles, footwear and tobacco.

14.4.2 Equity, fairness

Using a Computable General Equilibrium (CGE) approach, Mabugu & Chitiga (2007) find that a complete tariff removal on imports would harm the poor in the short-run but reduce poverty in the long-run. When the tariff removal simulation was combined with an increase in total factor productivity, the modelled short and long run effects were both positive in terms of welfare and poverty reduction.

A study (Edwards & Dunne, 2006) discovered that the effect of trade liberalisation has not been uniform across households and industrial sectors. There are both winners and losers in the process. Trade liberalisation has created new opportunities for exports and growth in services, but has also led to a decline, in output and employment, in many inefficient and import competing sectors. This makes it difficult

to measure the net impact of liberalisation on the poor. Whereas impoverished consumers have gained most from lower tariffs, they have not gained much in terms of employment. This is partly because poor households are largely disconnected from the formal wage economy and labour income in the traded sectors does not overlap geographically with the employed poor; and partly because economic and export growth has been insufficient to draw new entrants into the labour market.

All customs and excise duties collected within the Southern African Customs Union (SACU) are shared according to a complex revenue sharing formula. While customs revenues are of little importance to the South African fiscus, they are of considerable value to the smaller member countries of SACU. For example, in 2014, 60% of government revenues in Swaziland came from SACU customs duties. Government revenue and expenditure in these countries is therefore particularly sensitive to the total amount of customs duties collected. As a result, any reform of import tariffs needs to take account of the impact on households beyond the borders of South Africa.

14.4.3 Transparency and certainty

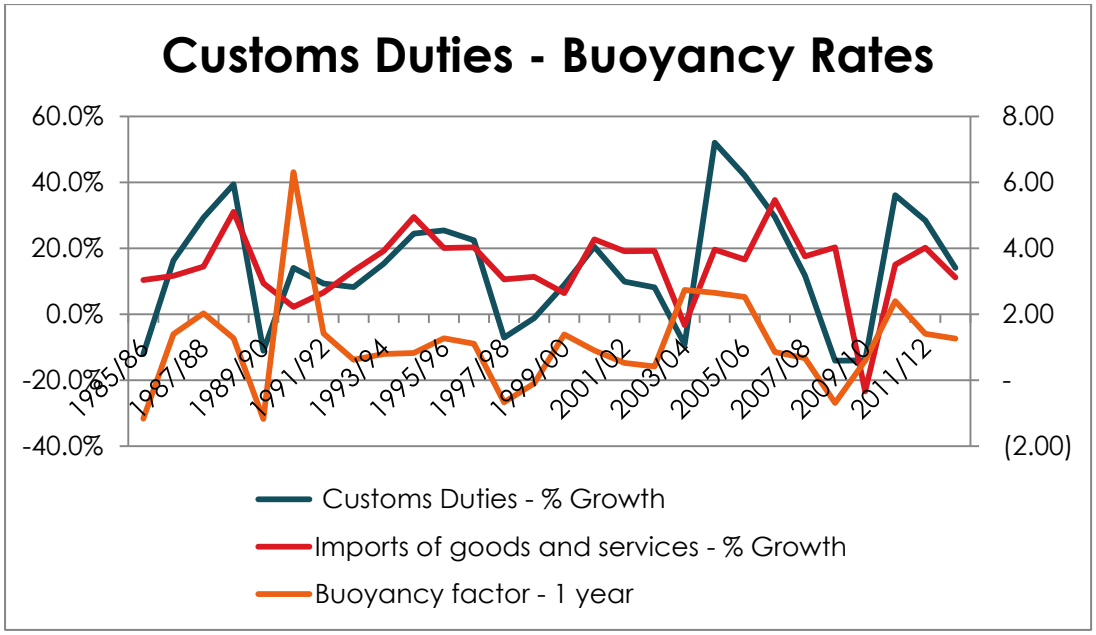
Tariffs are generally ad valorem, contributing significantly to tariff transparency. The reduction in the number of tariff lines has also contributed significantly to transparency and certainty.

The value for customs duty purposes is the transaction value. In cases where this value cannot be ascertained, the price paid for similar goods, adjusted for differences in cost and charges based on distance and mode of transport, is regarded as the transaction value. Alternatively, a computed value may be used based on production costs of the imported goods. In the case of related buyers and sellers, the transaction value will be accepted if, in the opinion of SARS, the relationship does not influence the price, or if the importer proves that the transaction value approximates to the value of identical or similar goods imported at or about the same time. There are, therefore, certain technical issues which raise the cost of compliance and administration.

14.4.4 Flexibility/buoyancy

Imports are particularly sensitive to the business cycle. The figure overleaf illustrates the large fluctuations in revenues from customs duty over the past 30 years.

Figure 10: Customs duties-buoyancy rates, 1985/86 to 2013/12



Source: Special request, SARS (2014)

14.5 Excise duty

Excise taxes are selective taxes on goods and services, whether imported or produced locally. In South Africa, specific excise duties are levied on alcohol and tobacco while ad valorem excise duties are levied on "luxury" items such as cosmetics, televisions and motor vehicles. Specific excise duties contribute about 3.5% to tax revenue; whereas ad valorem duty contributes only about 0.3% of tax revenue. While ad valorem duties are relatively insignificant as a source of revenue, they have a very specific goal (that of enhancing equity) which merits discussion.

14.5.1 Efficiency (economic and administrative)

Excise taxes levied on alcohol and tobacco aim to correct a market failure; that is, the negative external costs of these products are not necessarily reflected in the retail price of these goods. As such, these taxes are deliberately designed to distort consumer behaviour. By raising the price of socially harmful goods such as alcohol and tobacco, demand is reduced.

Economy-wide modelling (PROVIDE, 2006) has been used to show that an increase of 10% in excise duties on alcohol would reduce real household consumption expenditure by over R300 million (in 2006 prices) and cause a loss of almost 7500 jobs, mainly in the agricultural sector. However, the authors of this study emphasise that they did not take into account the negative externalities associated with excessive alcohol consumption, such as productivity loss, foetal alcohol syndrome or traffic accidents. In other words, the results do not capture the benefits from any reduction in negative externalities following the decline in demand due to a price increase in alcoholic beverages; hence, their estimates represent an upper bound of any welfare losses.

Ad valorem excise duties are selectively applied to a small range of goods. As such, they distort the prices of certain ("luxury") goods and create deadweight losses. Therefore, from a purely economic efficiency standpoint, ad valorem taxes are

inefficient. The deadweight loss, as noted, is a function of the square of the tax rate: thus the higher the rate, the more inefficient the tax.

Administratively, excise duties are expensive to collect. In the case of ad valorem duties, the schedules are relatively complex so that the classification of goods into the correct category is a labour-intensive process which has imposed an administrative burden on both the revenue authorities and firms. In the case of the specific excise taxes, the high rates imposed on alcohol and tobacco require extensive and expensive efforts to curb tax evasion.

14.5.2 Equity, fairness

Taxes on alcohol and tobacco are undoubtedly regressive (Bird & Wallace, 2006 and PROVIDE, 2006). While the poor spend less on alcohol and tobacco in absolute terms, these items make up a larger proportion of their overall household consumption. Specific excise duties are particularly regressive because the tax is based on quantity rather than price. For example, the excise duty (in 2014) on a litre of wine was R3.31, i.e. R2.48 per 750 ml bottle. Whereas an impoverished person may buy a bottle of wine for R20 (and thus be paying a tax rate of 12%), a rich person may purchase one for R200 (and thus only incur a 1% tax).

Ad valorem duties on luxury goods are intended to be progressive as they target goods which are more likely to be consumed by the non-poor, such as motor vehicles, perfume and golf clubs. While some of the items that incur ad valorem excise duty are also consumed by the poor – e.g. cell phones and television sets – these are items where large price and quality differentials exist; hence their regressivity is less pronounced than in the case of specific duties.

14.5.3 Transparency and certainty

The excise duty schedule is relatively simple and transparent. For example, the alcohol excise duty rate structure differentiates between alcoholic beverages in accordance with benchmarks determined in 2002 and adjusted in 2012. The total consumption tax burden (excise duties plus VAT) as a percentage of the weighted average retail selling price for wine, clear beer and spirits was set at 23%, 33% and 43% respectively, in 2002. In the 2012/13 fiscal year the targets for beer and spirits were raised to 35% and 48% respectively. Adjustments are made annually to maintain the targeted indirect tax burdens (National Treasury, 2014).

14.5.4 Flexibility/buoyancy

We were unable to find any empirically based estimates of the buoyancy of excise duties in South Africa. Theoretically, one would expect that revenue from specific excise duties on alcohol and tobacco would be relatively unresponsive to changes in the tax base since the demand for these goods is quite inelastic.

14.6 Summary of individual tax handles

Table 18, below, summarises the assessment of the individual tax handles in relation to an effective tax system.

Table 18: Evaluation of the major South African tax handles against the principles of a good tax system

A Good Tax System	Current SA Tax System

VAT	
1. Efficiency (economic and administrative)	VAT is an efficient, broad-based tax with few zero-ratings and exemptions, ensuring minimal distortions. Small vendors are excluded to increase administrative efficiency.
2. Equity, fairness	VAT is mildly progressive due to zero-rating
3. Transparency and certainty	VAT is transparent; high degree of certainty.
4. Flexibility/Buoyancy	VAT is a buoyant tax.
Customs Duties	
1. Efficiency (economic and administrative)	Quite efficient. Customs duties are low and generally well aligned with excise duties.
2. Equity, fairness	Somewhat progressive as some luxury items attract a higher rate of customs duty.
3. Transparency and certainty	Quite transparent and simple to apply
4. Flexibility/Buoyancy	Revenue follows the business cycle, thus being buoyant.
Excise Duties	
1. Efficiency (economic and administrative)	Helps to internalise the cost of externalities associated with drinking and smoking. Administrative burden for the revenue authorities is high.
2. Equity, fairness	Ad valorem duties are progressive, while specific duties are regressive.
3. Transparency and certainty	Quite transparent; relatively simple to apply by international standards.
4. Flexibility/Buoyancy	Revenue is not very responsive to the business cycle.
Personal income tax	
1. Efficiency (economic and administrative)	There are concerns that high marginal tax rates disincentivise labour supply (either in terms of participation or working hours). The international mobility of skilled and semi-skilled workers in an internationally integrated labour market represents a further factor to be considered.
2. Equity, fairness	The PIT structure is progressive. The PIT reforms over the last two decades have not really resulted in an improvement of the income distribution. Furthermore, there is some consensus that personal income taxation is not a very suitable instrument for redistribution purposes in developing countries (Steenekamp, 2012a).To the extent that capital gains accrue primarily to upper income taxpayers, the progressivity of the income tax and hence the vertical equity of the tax system were enhanced.
3. Transparency and certainty	The simplification of the PIT system and the introduction of e-filing have made the system admirably transparent and simple. Transparency is also enhanced by the fact that the bracket creep is kept in check by regular adjustments of the brackets and rebates on an ad hoc basis.
4. Flexibility/Buoyancy	The PIT is an automatic stabiliser due to its built-in flexibility towards counter-cyclical economic behaviour.
Corporate income tax	
1. Efficiency (economic and administrative)	Economically inefficient and non-neutral. Effectiveness of the incentive regime is uncertain.
2. Equity, fairness	Fairly progressive in that the top decile bears most of the incidence. This is somewhat offset by regressive elements associated with shifting of the incidence onto consumers and onto institutional investors such as pension funds.
3. Transparency and certainty	Increasing complexity of the legislative framework has tended to decrease certainty by being more open to different interpretation and to decrease transparency.
4. Flexibility/Buoyancy	Very cyclical in nature, contracts markedly in recessions and lingers, because past assessed losses are offset against taxable income in later years. CIT is a buoyant tax.

14.7 Holistic assessment of the tax system

In general, as indicated, most taxes influence people's behaviour in distortionary ways and all reduce the welfare of those who bear their economic burden. The challenge for tax design is to finance the achievement of social and economic policy objectives while minimising these welfare-reducing side effects. In achieving the overall objectives of the tax system, it is important to consider all taxes (and transfer payments) together as a system (taking a systemic and holistic view) while at the same time being clear about the role of each tax within the system. Furthermore, it is important to note that it is the redistributive impact of the system as a whole which needs to be measured and judged. Not every tax needs to be progressive as long as the overall system is (Mirrlees, et al., 2011). The evaluation of a tax system should always be informed by the benefits made available to the public through effective and efficient public expenditure and the distribution of both the benefits and the burden of taxation. The revenue side cannot be divorced from the expenditure side. The developmental impact of public expenditure legitimises the system of taxation. In other words, the combined effects of an appropriate tax system and an efficient and productive expenditure system ensure that the fiscal system supports economic growth (National Treasury, 2012).

The cost of revenue collection (calculated by dividing the cost of internal operations by total tax revenue collected) – an important indicator of the efficiency of a revenue administration – has remained between 1.17% in the 2009/10 financial year and 0.97% in the 2013/14 financial year. The ratio in the financial year 2012/13 was 1.07%. Internationally, the benchmark is 1% (SARS, 2013; National Treasury, 2014; SARS/NT, 2013).

The South African tax system is compared to the criteria for an effective tax system in Table 19.

Table 19: Overall assessment of the South African tax system against the criteria for a good tax system

A Good Tax System	Current Overall SA Tax System
1. Neutrality *The tax system must produce sufficient income for the state, with minimum distortions to the economy***.**	Not enough empirical evidence on behavioural responses to ascertain whether the South African tax system is neutral.
2. Simplicity *As far as possible, taxes should be simple to understand and should be collected in a timely and convenient manner.*	Tax reforms have made the system simpler and somewhat reduced loopholes. Simplicity, ease of administration and lower compliance costs are important and must be enhanced. Tax policy simplification should attempt to integrate the small business tax systems within the general tax system.
3. Stability *The tax system must stay stable to support macroeconomic stability.*	In good times, tax levels rise while in bad times they fall, providing an automatic stabiliser to the economy. It is important to ensure that the tax system contributes towards the counter-cyclical fiscal policy framework. However, the tax system tends to be cyclical because of the high proportion of company taxes in the tax system.
4. Revenue Adequacy *The tax system must raise sufficient revenue to meet Government's expenditure needs and foster a stable macroeconomic environment.*[30]	Tax revenue as a percentage of GDP (Tax/GDP ratio) has remained steady, averaging 25% during between 2010/11 and 2012/13. This is nevertheless, significantly lower than the percentage achieved before the global financial crisis when the Tax/GDP ratios exceeded 27%. The revenue raising potential of the tax system must not be compromised.

Overall, tax reform initiatives must be guided by the following general principles:

- The long-run objective for all economic policy instruments is to support sustainable growth and employment. Efficient allocation and use of all resources, including tax revenue, are key in pursuing these objectives
- The primary priority for tax reform must be to remove distortions within the tax system in order to move toward greater neutrality. This would prevent arbitrage to avoid paying taxes and encourage decision making based on economic fundamentals
- The tax system must be stable and buoyant, ensuring a steady revenue stream for Government. In accordance with the principle of stability, there should not be constant changes in tax policy and legislative changes should be kept to the minimum. Most importantly, policy direction should be clear. While changes in legislation are inevitable and the tax law should be sufficiently flexible to respond to changes in economic conditions, it is important that changes are not arbitrary and follow a clearly defined, coherent strategy. To this end, the principle of stability is complementary to the principles of simplicity, transparency and certainty
- The total tax to GDP ratio should be reasonable and appropriate to finance the country's development needs

[30] For a more accurate assessment, a sense of the overall magnitude of the Government's expenditure needs must be established.

- The tax system functions as an interconnected system, and the impacts as a result of changes to individual tax instruments should consequently be evaluated holistically
- The number of separate tax instruments and the volume of provisions should be limited to prevent fragmentation of the tax bases
- An appropriate mix is sought between taxes on consumption, income and wealth
- The overall tax system should remain progressive. It should be noted, however, that redistribution is often more effective through appropriate and efficient Government expenditure programmes
- Tax rates should be set at appropriate levels to minimise distortions of economic activity and reduce the disincentive effects on work effort, savings and investment
- Minimal use should be made of tax incentives; a thorough analysis of objectives and alternatives must be undertaken before incentives are considered. When new incentives are introduced, a thorough system for monitoring and evaluation should also be designed
- There is a need to minimise administration and compliance costs
- Tax reform should be a transparent process, built on broad moral consensus regarding the most appropriate tax regime for the particular social, economic and political circumstances of South Africa (National Treasury, 2012).

15 AREAS FOR FURTHER RESEARCH

The key challenge of the DTC is to devise/strengthen tax policies that will be perceived as “fair” and help build social cohesion while supporting inclusive growth. As has been noted earlier in this document, the *NDP Vision 2030* emphasises the need to improve public infrastructure, finance NHI and comprehensive social security reform as well as expand vocational training, amongst other objectives. In addition to these longer term policy objectives, in the medium term the need for fiscal consolidation is likely to dominate the fiscal policy discourse. While such consolidation must begin with expenditure reprioritisation, improvements in the effectiveness of public spending, the elimination of corruption and the reduction in wasteful spending, the issue of raising additional revenue cannot be ruled out. Can this be achieved by improving compliance and broadening the tax base or will statutory tax rates need to be raised? If tax rates need to be raised, which taxes will be the least distortionary? How should efficiency and equity considerations be balanced?

In order to pursue a sensible tax policy it is essential to perceive the tax system as a system rather than to consider its different elements in isolation (Mirrlees, 2010). The overall effects of any reform on the fiscal regime as a whole should be considered and not just at whether individual taxes are progressive or regressive. The distribution of disposable incomes depends both on taxes and the benefits financed through those tax revenues. Raising indirect tax rates, for instance, is regressive, but the overall impact might still be progressive if these effects are offset by benefit changes on the expenditure side. For example, increasing the size of social grants may be a more efficient way of increasing the disposable income of poorer households than reducing the rates of indirect taxes.

Identifying tax policy research gaps

The brief foray into the international tax literature in this Framework Document reveals that, while there are several theoretical models, empirical findings are sometimes ambiguous and highly context specific. While international trends are certainly useful benchmarks (especially in relation to other emerging markets and African counterparts), these are mediated by so many other factors (e.g. the level, composition and impact of public spending, the structure of the economy, political and labour market institutions and so forth) that they serve as useful points of departure but cannot be authoritative.

Rather surprisingly, given the importance of the tax system, there is very little recent quantitative analysis of the nexus between the tax system, growth and employment in South Africa, either within Government or in academia. A growing body of empirical South African literature exists in relation to certain tax instruments, e.g. PIT and VAT. However, comparatively little work has been done on the economic impact at macro, sector and firm level in relation to CIT or CGT, for instance. There is also greater emphasis on the equity dimension and the progressivity of the tax system and individual tax handles, rather than their economic efficiency.

DTC efforts to review the South African literature suggest that there are large gaps in knowledge. Some unanswered questions (to name but a few) that have stemmed from our deliberations to date (and for which systematic empirical evidence is lacking) include:

- What is the relationship between economic growth, employment and tax rates and structure in South Africa? How best should policy-makers think about the mechanisms linking growth and tax rates (especially if inequality is inimical to growth)?
- How should the tax gap (compliance and revenue adequacy) be measured and closed?
- What is the relationship between marginal PIT rates and labour supply and how does this alter along with changing income levels?
- To what extent do higher tax rates discourage investment in human capital and entrepreneurship?
- What are the effective tax rates on different economic sectors, especially given the potentially wide deviation from statutory rates?
- Empirically, have incentives worked, in terms of quantum and timing of additional investment and employment (in terms of participation and hours worked) relative to the size of the subsidy?
- What is the incidence of CIT by income decile given the product and labour market dynamics in South Africa?
- What is the extent of user charges in South Africa? How have they evolved post-Katz? What should be the weight accorded to the benefit principle of equity as opposed to the ability to pay?
- How can the tax system be altered in order to encourage the formalisation of the informal sector?

- Is there a case for additional provincial and municipal tax instruments? For instance, should a local business tax be considered?

The above list of issues alone constitutes a rather formidable long term agenda. In the short to medium term it is unlikely that conclusive evidence will be available for all these issues. *It is the DTC's fervent wish that academia and other research institutions will engage with tax policy issues such as these, to a much greater extent.* International research is very useful, but behavioural responses to tax policy may differ widely across countries depending on their socio-economic and tax administration context. A South Africa-specific empirical evidence basis is crucial for informed tax policy reform.

Data availability has been a key constraint on the ability of researchers to engage in empirical tax policy research. SARS has begun to make aggregated tax data available annually in its *Tax Statistics* publication on its website. This is highly commendable. However, understanding behavioural responses often requires analysis at the individual taxpayer level. Striking the balance between a sufficient level of aggregation for credible empirical research and preserving taxpayer confidentiality becomes a complex terrain to negotiate. Pooling data from different data sets could also pose a formidable challenge. For example, when SARS' administrative classification systems differ from the Standard Industrial Classification, the former need to be reconciled with the latter.

The lack of an existing, comprehensive, analytically sound body of econometric knowledge poses a very real obstacle to the DTC's aspiration to present defensible, evidence-based recommendations within a systematic, internally consistent macro framework. The current research base is sparse and there is an array of empirical unknowns and data as well as other constraints.

While there is some work that examines tax structure and economic growth (e.g. Koch, Schoeman & van Tonder, 2005) the Committee was unable to find any research that comprehensively investigated tax structure, employment and growth in an economy-wide framework, as well as the related distributional impacts. Existing macroeconomic models are designed to study marginal changes in tax policy. Moreover, the welfare effects of small tax reforms are typically analysed through a static micro-simulation approach that ignores behavioural effects. In practice, however, all tax reforms are necessarily small, making it foolhardy to simply ignore the behavioural responses.

To understand the relationship between tax, economic growth and employment, economy-wide quantitative analysis would be important to inform the DTC's deliberations. However, such work will be extremely difficult to accomplish for a number of reasons: the questions we are asking may not be conceptually answerable given the current status of econometric tools; even if the techniques are feasible, the skills and data to execute the approach effectively may not be available to the Committee.

Cutting edge studies in countries such as Germany have yielded modelling approaches which may not be relevant or replicable here. These approaches employ macroeconomic and economy-wide (computable general equilibrium (CGE))

modelling techniques as well as micro simulation modelling so as to fine tune and empirically validate the relationships between taxes and the economy which are assumed by the CGE models.

The micro modelling would ideally contain two parts: the first would look at determining effective tax rates which influence actual economic behaviour (i.e. inclusive of deductions and exemptions) rather than the statutory rates. The second component of the micro work would look at the distributional impact of tax changes on the household sector, the cost-benefit analysis of tax incentives on firms in particular sectors, etc. Such a comprehensive, integrated modelling approach is very skills intensive and requires expertise in a number of economics specialities (i.e. econometric macro modelling, tax analysis and micro-simulation of households' and firms' responses).

Laying the foundations of quality empirical tax research in South Africa: DTC progress to date

In order to address some of these gaps, the DTC has sought to collaborate with key stakeholders in the research projects listed below:

1. **Estimating sectoral marginal effective tax rates and average effective tax rates** for the South African economy: The DTC has solicited technical support from a World Bank team and a researcher from the University of Stellenbosch to update a previous study conducted in 2006. Part 1 of the study is available on the DTC website. Part 2, which conducts a firm level study of the user cost of capital and investment elasticities, will be released soon.
2. **Mining sector regime benchmarking**: The IMF applied its Fiscal Analysis of the Resource Industries (FARI) model to South Africa to explore the economic linkages vis-à-vis the mining sector, economic growth, balance of payments, tax and royalty revenues in a number of scenarios and compare the findings to countries in Africa and elsewhere. The report is available on the DTC website.
3. **Economic impact of VAT:** The National Treasury is currently undertaking modelling of tax revenues, economic growth, employment, investment, consumption and household welfare.
4. **The impact of the tax system on the factor intensity of production**: The aim of this project would be to assess whether the current tax regime (e.g. through capital depreciation allowances and other incentives) has systematically encouraged capital intensive production methods rather than labour intensive ones. This research will be conducted by the National Treasury.
5. **Measuring the VAT gap**: The IMF and SARS collaborated on a project to measure the difference between potential VAT revenue and actual tax collections. The work measures the "policy gap" (i.e. revenue that is foregone because of zero-ratings, exemptions, special treatments) and the "compliance gap". This may clarify whether there are possible strategies for mobilising additional revenue without changing the standard VAT rate. The report is available on the DTC's website.

While these projects are an important start to building a rigorous body of tax policy research, the DTC recognises that achieving this can only result from collaboration

between all research institutions with the capacity to conduct tax policy research. To this end, the DTC has already begun engaging with academic researchers active within the field and other research institutions, so as to communicate these research gaps and encourage the pursuit of a long term research agenda which speaks to these pressing yet perplexing tax policy issues.

16 KEY THEMES AND CONCLUDING REMARKS

The previous section outlined the various gaps in knowledge about the South African tax system. This section summarises the key themes and findings of this Framework Document and their implications for the DTC.

16.1 Key Themes/Stylised Facts

1. The primary challenge of the South African tax system is to achieve revenue adequacy while supporting growth that would stimulate employment and reduce poverty and inequality. There are concerns that the potential output of the South African economy has declined (rather than merely reflecting cyclical fluctuations), which would have serious consequences for tax policy in a chronically weak global economy. The accumulation of public debt will limit borrowing in the medium term, especially given credit rating downgrade pressures on the sovereign rating. The increase in the public sector compensation of employees as a share of total spending creates increased spending rigidities that are difficult to adjust downwards, unless increases in public sector wages can be curtailed in the forthcoming public sector wage bargaining round or a decrease in public sector employment occurs (in an environment where private sector employment is subdued).

2. The tax system consists of a number of different tax instruments with different objectives: PIT is redistributive and imparts a strong element of progressivity in the system. Inchauste et al. (2015) demonstrate that the top 10% of households paid 87% of the total PIT yield. The CIT and CGT also help to ensure a fair distribution of the tax burden, but in a globally integrated economy they must also be competitive in order to attract investment. The broad based VAT system raises revenue fairly efficiently while zero rating mitigates much potential regressivity. The same study by Inchauste et al. (2015) has even found VAT to be mildly progressive (because of the zero-ratings on basic food items): an unexpected finding. Excise taxes on alcohol and tobacco are regressive, but have a strong public health policy rationale.

3. Overall, the tax system is slightly progressive, with progressive direct taxes compensating for more regressive indirect taxes. However, the South African tax system is less progressive than countries such as Brazil and Mexico, indicating that there may be some room for more progressivity in the tax system. The Kakwani Index is a measure of tax progressivity. If greater than zero, the index would suggest a progressive tax system, if equal to zero, a neutral one, while a negative index would suggest a regressive tax system where the poor pay proportionally more of their share of income in tax compared to the richer income deciles. The Kakwani Index is 0.028 for South Africa (Inchauste et. al. (2015), which is broadly similar to Brazil (0.039) (Higgins & Perreira, 2014) but much lower than a country such as Mexico (0.109) (Scott, 2014).

4. It is difficult, nevertheless, to assess the impact of the tax system on inclusive growth, without simultaneously considering the impact of public expenditure. Recent studies such as the 2014 World Bank Report, *Fiscal Policy and Redistribution in an Unequal Society*, confirm that South African public spending is highly progressive: social grants are well targeted and the access of the poor to basic services such as health, education, water, sanitation and electricity has improved markedly. All of these contribute substantially to reduction of poverty and equality. The poorest 10% of households receive public services and grants to the value of R6 900 per capita per year from Government (or $945 in 2010/11) while paying R724 ($99) in taxes (such as VAT and excises).

5. The quality of education and health remains a serious problem. Despite additional public funds being pumped into social and economic infrastructure, delivery, water and electricity infrastructure pose binding constraints on economic growth. Because of poor delivery capacity, unspent budget allocations co-exist with service backlogs; in addition, serial and material overspending on infrastructure projects is a regular occurrence, as evidenced by Auditor General Reports. High levels of inefficiency of public service spending, waste and outright corruption persist.

6. As compared to other developing countries, the South African tax and public expenditure system is highly efficient in redistribution. However, because income inequality is so extreme to begin with, the outcome after the application of fiscal policy remains greater than in comparable developing countries. In 2010, the fiscal system reduced South Africa's Gini Coefficient from 0.771 to 0.596 after fiscal policy was applied. By contrast, Brazil's Gini Coefficient in 2009 was 0.579 (lower than the South African Gini even after fiscal policy has been implemented) and declined to 0.439 after fiscal policy had been applied.

7. Achieving NDP aspirations of a reduction in poverty and inequality and its laudable ambitions for NHI and social security reform in a very tight fiscal environment will require more effective uses of available public resources. These include expenditure reprioritisation and impact reform, improving the administration (e.g. transfer pricing, BEPS) and estate planning loopholes which allow the rich to avoid paying their fair share, as well as using the tax system to finance these policies in a manner which is as inclusive and growth enhancing as possible.

8. For a number of reasons not much is known about the efficiency of corporate taxation, including issues such as the lack of survey data at the level of the firm and the need to maintain taxpayer confidentiality in highly concentrated industries, amongst other factors. Preliminary research indicates that the average effective tax rate (the ratio of a company's tax liability to its net pre-tax accounting profit) varies substantially by sector. Average effective tax rates may diverge from the statutory CIT rate of 28%, as some companies are liable for CIT at different rates due to special dispensations and deductions. This raises questions about the horizontal equity and the economic efficiency of the CIT system, which require further investigation by the DTC.

9. The METR is a measure of the effective rate of tax imposed on the rate of return generated by the last, or marginal, unit of capital in which a firm invests. The METR gives an indication of the differences across economic sectors of the tax cost associated with R1 of extra investment. It therefore reflects how the effective after-tax returns to new investments differ between sectors. Initial research suggests that METRs also differ markedly across sectors, being negative in sectors which are able to access capital tax deductions and other investment incentives (such as manufacturing). It is important that the METRs which are a product of the tax system be aligned with industrial policy. The DTC has requested that the World Bank provide technical assistance in determining and analysing average and marginal effective tax rates across sectors in South Africa.

10. In general, a survey of relevant South African research and of submissions received by the DTC indicates that the tax system does not emerge as a major impediment to growth per se. The tax challenges were considerably overshadowed by policy uncertainty in relation to property rights (e.g. in the mining, agriculture and other sectors), labour market issues, infrastructure constraints on water and electricity, other forms of regulatory red tape and so on. However, an argument which frequently recurred was the need for increased tax incentives as a "sweetener" to counteract the policy uncertainties and attract investments. Small and medium sized enterprises face their own specific challenges; these were dealt with in a separate DTC report. The overall complexity of the CIT system is a cause for concern and simplification should be a priority.

11. Base erosion and profit shifting concerns loom large, but this too is the subject of a separate DTC report, which will discuss the protection of the South African tax base in detail.

16.2 Concluding remarks

Ideally, NDP priorities should be financed from increased tax revenues generated as a result of stronger economic growth, improved tax compliance, expenditure reprioritisation, elimination of inefficiency and corruption and increased effectiveness of public spending. Should the tax system be required to generate additional revenue, the DTC urges that the following long term principles be borne in mind, in order to minimise the impact on economic growth and employment:

1. *Progressivity in the overall tax system is an important consideration and we recognise the need to enhance this.* However, it is important to note that a great deal of redistribution happens on the expenditure side of the budget. Higher direct taxes are likely to reduce growth which will, in turn, reduce tax revenue and limit the ability of the fiscal system to redistribute in the future.

2. *If increased revenue becomes important, trade-offs associated with the choice of tax mix should be carefully considered in terms of their impact on inclusive growth.* As discussed in Section 9 above, at the request of the DTC, the National Treasury has modelled a number of simulations. An increase in PIT would need to be 6 percentage points while the increase in CIT would need to be 5 percentage points in order to realise the same revenue as a 3 percentage point increase in VAT. While there would be a negative impact on

GDP and employment – particularly in the short run – the impact of a VAT increase on these two variables would be less severe than that of a rise in PIT or CIT. An increase in VAT would be less distortionary than an increase in PIT or CIT, but would counter the overall progressivity of the tax system and be somewhat inflationary in the short run. Increases in PIT, on the other hand, could enhance progressivity but may encourage tax avoidance behaviours, reduce labour supply, prompt the flight of those who are skilled and undermine incentives for entrepreneurship.

3. *The tax system must not be used to offset pathologies in other parts of the system (e.g. in respect of property rights or labour market challenges).* If other elements of public policy are unclear or problematic, these should be dealt with at source and not compensated for by the tax system.

While measures may be taken in the short term to raise additional revenue, these should not compromise these longer term objectives of the tax system geared to stimulating inclusive growth.

----------END----------

17 REFERENCES

Aaron, H. J. & Slemrod, J. (1999). *The South African Tax System: The Nation in Microcosm.* http://www.brookings.edu/research/articles/1999/12/06africa-aaron [accessed 13.9.2013]: Brookings Institute.

Amendola, M., Gaffard, J.-L. & Patriarca, F. (2013). *Inequality, Debt and Taxation: The Perverse Relation between the Productive and the Non-productive Assets of the Economy.* Groupe de Recherche en Droit, Economie, Gestion (GREDEG).

Amusa, A. (2004). A Macroeconomic Approach to Estimating Effective Tax Rates in South Africa. *SAJEMS NS, 7*(1), 117-131.

Bird, R. A. (2007). *The VAT in Developing and Transitional Economies.* Cambridge: Cambridge University Press.

Black, P. A., Calitz, E. & Steenekamp, T. J. (2011). *Public Economics.* 5th edition. Cape Town: Oxford University Press Southern Africa.

Black, P., Calitz, E. & Steenekamp, T. (2015 (forthcoming)). *Public Economics.* 6th edition. Cape Town: Oxford University Press.

Calitz, E., Wallace, S. & Burrows, L. R. (2013). *The Impact of Tax Incentives to Stimulate Investment in South Africa.* International Centre for Public Policy, Working Paper 13-06, April 2013.

Casale, D. (2012). Indirect Taxation and Gender Equity: Evidence from South Africa. *Feminist Economics, 18(3)*, 25-54.

DEMACON. (2013). *Urban Development Zone Impact Study.* Pretoria: National Treasury.

Diamond, P. & Mirrlees, J. (1971). Optimal Taxation and Public Production II: Tax Rules. *American Economic Review*, *61(3)*, 261-78.

Duclos, J.-Y. & Verdier-Chouchane, A. (2011). Analysing Pro-Poor Growth in Southern Africa: Lessons from Mauritius and South Africa. *African Development Review, 23*(2), 121-146.

Ebrill, L. K. (2001). *The Modern VAT.* Washington DC: International Monetary Fund.

Edwards, L. & Dunne, P. (2006). Trade and Poverty in South Africa: Exploring the Trade-Labour Linkages. Cape Town: Paper prepared for the South African Trade and Poverty Research Project, SALDRU.

FIAS. (2006). Sector Study of the Effective Tax Burden, South Africa. Foreign Investment Advisory Service, A joint service of the International Finance Corporation and The World Bank. http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2011/01/06/

000356161_20110106003437/Rendered/PDF/588250WP0South10BOX353820B01PUBLIC1.pdf, [accessed 13.9.2013].

Financial and Fiscal Commission. (2012). Submission on the Application from eThekwini Metropolitan Municipality for the Authorisation of a Local Business Tax. Midrand: Financial and Fiscal Commission.

Financial and Fiscal Commission. (2012). Sustaining Municipal Finance: Making Local Government Work. Midrand: Financial and Fiscal Commission. http://www.ffc.co.za/index.php/component/docman/doc_download/175-municipal-fiscal-framework-formal-problem-statement-publication-corrected-february-10-2012-no.html [accessed 5.10.2013]

Förster, M., Llena-Nozal, A. & Nafilyan, V. (2014). *Trends in Top Incomes and their Taxation in OECD Countries.* OECD Social, Employment and Migration Working Papers, No. 159.

Geiger, R., Kermode, P. & Owens, J. (2013). *Developing a Tax Environment for Growth and Competitiveness.* Institute for Austrian and International Tax Law of the WU (Vienna University of Economics and Business); Association Internationale de Droit Economique and the European Commission.

Gruber, J. (2009). *Public Finance and Public Policy.* 3rd edition. New York: Worth Publishers, Incorporated.

Higgins, S. & Perreira, C. (2014). The Effects of Brazil's Taxation and Social Spending on the Distribution of Household Income. *Public Finance Review,* 42(3), 346-367.

IMF. (2013a). *Taxing Times, Fiscal Monitor October 2013.* Washington, DC: International Monetary Fund.

Inchauste, G., Lustig, N., Maboshe, M., Purfield, C. & Woolard, I. (2015). *The Distributional Impact of Fiscal Policy in South Africa.* Washington DC: World Bank.

James, S. (2013). *Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications.* Washington DC. World Bank Group.

JSCOF (2003) Final Draft Report of the Joint Standing Committee on Finance on *The Third Interim Report of the Katz Commission of Inquiry into Taxation*, http://www.treasury.gov.za/publications/other/katz/3.pdf [accessed 3.10.2013]

Johansson, Å., Heady, C., Arnold, J., Brys, B. & Vartia, L. (2008). *Tax and Economic Growth.* OECD Economics Department Working Papers, No. 620.

Jooste, C. (2013). *Optimal Labour Income Tax Rates: Can We Push the Margins?* Pretoria: National Treasury.

Jooste, C. & Naraidoo, R. (2011). Nonlinear Tax Elasticities and their Implications for Structural Budget Balance. *Journal of Applied Business Research, 27*(4), 113-125.

Koch, S., Schoeman, N. & van Tonder, J. (2005). Economic Growth and the Structure of Taxes in South Africa: 1960-2002. *South African Journal of Economics*, 73(2):190-210.

Mabugu, R. & Chitiga, M. (2007). *South Africa Trade Liberalization and Poverty in a Dynamic Microsimulation CGE model.* Pretoria: University of Pretoria, Department of Economics Working Paper Series, No. 2007-18.

Mirrlees, J. (2010). *Dimensions of Tax Design: The Mirrlees Review.* Oxford: Oxford University Press.

Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. & Poterba, J. (2011). *Tax by Design: the Mirrlees Review. Conclusions and Recommendations for Reform.* Oxford: Oxford University Press.

National Treasury. (2007). The VAT treatment of Merit Goods and Services. Unpublished.

National Treasury. (2012). *Tax Policy Principles and Tax Reform in South Africa.* Pretoria: National Treasury: Economic Tax Analysis, Tax Policy Unit, Tax and Financial Sector Policy Division.

National Treasury. (2014). *Budget Review 2014.* Pretoria.

National Treasury. (2015). *Budget Review 2015.* Pretoria.

OECD. (2007). *Tax and Economic Growth: A Progress Report.* OECD Economics Department and the OECD Centre for Tax Policy and Administration.

OECD. (2012). *Looking to 2060: Long-term Global Growth Prospects.* The OECD Economic Policy Paper Series, No. 03.

OECD. (2013a). *Addressing Base Erosion and Profit Shifting.* http://dx.doi.org/10.1787/97892641192744-en: OECD Publishing.

OECD. (2013b). *New Approaches to Economic Challenges. Tax Design for Inclusive and Sustainable Economic Growth in OECD Countries: A Scoping Note.* OECD, Centre for Tax Policy and Administration, CTPA/CFA/WP2(2013)28.

Parliament. (2000). *Final Draft Report of the Joint Standing Committee on the Third Interim Report of the Katz Commission of Inquiry.* Cape Town: Joint Standing Committee on Finance, Parliament.

Piketty, T. (2014). *Capital in the Twenty-First Century.* Éditions du Seuil. Harvard University Press.

Power, M. (2013). *Advertised Price is a Flight of Fancy.* Sunday Times, December 1, 2013.

PROVIDE. (2006). *The Impact of Increasing Excise Duties on the Economy.* Elsenburg: PROVIDE Project.

World Bank and PWC (2015) *Paying Taxes 2016, Tenth Edition.*

SARS. (2013). *South African Revenue Service, Annual Report 2012- 2013.* SARS, ISBN: 978-0-621-42084-5.

SARS/NT. (2013). *Tax Statistics.* Pretoria: Joint publication between National Treasury and the South African Revenue Service.

Scott, J. (2014). Redistributive Impact and Efficiency of Mexico's Fiscal System. *Public Finance Review*, *42(3)*, 368-390.

Sky News 2012 Starbucks: No UK Tax Paid Since 2009, http://news.sky.com/story/998230/starbucks-no-uk-tax-paid-since-2009

South Africa. National Planning Commission. (2012). Our future - make it work. Pretoria: http://www.npconline.co.za/MediaLib/Downloads/Downloads/NDP per cent202030%20-%20Our%20future%20-%20make%20it%20work.pdf, [accessed 15.9.2013].

Steenekamp, T. (2007). Tax Performance in South Africa: A Comparative Study. *Southern African Business Review, 11*(3), 1-16.

Steenekamp, T. (2012a). The Progressivity of Personal Income Tax in South Africa since 1994 and Directions for Tax Reform. *Southern African Business Review, 16*(1), 39-57.

Steenekamp, T. (2012b). Taxing the rich at higher rates in South Africa? *Southern African Business Review, 16*(3), 1-29.

Stern, R. (2005). *Designing a Small Business Tax System that Enhances Growth: Lessons from Africa.* Washington DC: World Bank Group.

Vale Columbia Center. (2013). *Investment Incentives: The Good, the Bad and the Ugly. Assessing the Costs, Benefits and Options for Policy Reform.* Background Paper for the Eighth Columbia International Investment Conference. Investment Climate Advisory Services of the World Bank Group.

Valodia, I., Smith, T. & Budlender, D. (2001). Has Gender-Based Tax Reform been Good for all South African Women? *Agenda: Empowering Women for Gender Equity 16:*47, 83-88.

van der Berg, S. (2009). *Fiscal Incidence of Social Spending in South Africa, 2006.* Stellenbosch Economic Working Papers: 10/09.

van der Berg, S., & Moses, E. (2012). How Better Targeting of Social Spending Affects Social Delivery in South Africa. *Development Southern Africa, 29*(1), 127-139.

van Heerden, Y. (2008). *Finding the Optimum Tax Ratio and Tax Mix for Maximising Growth and Revenue in South Africa.* http://upetd.up.ac.za/thesis/available/etd-10192009-172718/unrestricted/dissertation.pdf [accessed 12.12.2013]: Master's Dissertation, University of Pretoria.

World Bank (2015) *Sector Study of Effective Tax Burden and Effectiveness of Investment Incentives in South Africa-Part I*. Available at:

http://www.taxcom.org.za/docs/Sector%20Study%20of%20Effective%20Tax%20Burden%20in%20South%20Africa%20-%20Part%201%20-%20June%202015.pdf, [accessed 13.9.2013].

World Bank Group, & PWC. (2016). *Paying Taxes 2016, 10th Edition.*

Woolard, I., Simkins, C., & Oosthuizen, M. (2005). *Final Report: Tax Incidence Analysis for the Fiscal Incidence Study being conducted for National Treasury.* USAID/South Africa through Nathan Associates SEGA/MESP Project.

ANNEXURE 1: THE MANDATE OF THE DAVIS TAX COMMITTEE

The Minister of Finance announced in the 2013 Budget that,

"***A tax review will be initiated this year to assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability…***"

In providing further details, this Terms of Reference draws from announcements already made in the 2013 Budget Review (BR).

1. Composition of Committee

Judge Dennis Davis will chair the committee. The other members are:

Prof Annet Wanyana Oguttu, Prof Matthew Lester, Prof Ingrid Woolard, Dr. Nara Monkam, Ms.Tania Ajam, Prof N Padia, Prof Thabo Legwaila and Ms Deborah Tickle. Two officials, one from the National Treasury, Mr Cecil Morden, and one from the South African Revenue Service, Mr Kosie Louw, will serve as ex-officio members in a technical, supportive and advisory capacity. In addition, the National Treasury and SARS will provide secretarial support to the Committee and SARS will provide office accommodation and logistical support to the Committee.

2. Terms of Reference

The terms of reference for the Tax Review Committee are to inquire into the role of the tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. The committee will take into account recent domestic and international developments and, particularly, the long term objectives of the National Development Plan.

The Committee is advisory in nature, and will make recommendations to the Minister of Finance. The Minister will take into account the report and recommendations and will make any appropriate announcements as part of the normal budget and legislative processes. As with all tax policy proposals, these will be subject to the normal consultative processes and Parliamentary oversight once announced by the Minister.

The committee should evaluate the South African tax system against internationally accepted tax trends, principles and practices, as well as recent international initiatives to improve tax compliance and deal with problems of base erosion.

The following aspects should receive specific attention from the committee:

1) An examination of the overall tax base and tax burden including the appropriate tax mix between: direct taxes, indirect taxes, provincial and local taxes. An analysis of the sustainability in the long-run of the overall tax-to-

GDP ratio, and the tax-to-GDP ratio for each of the three major tax instruments, personal income tax (PIT), corporate income tax (CIT) and VAT should be undertaken. This in essence requires an evaluation of the economic and social impact of the tax system and an assessment of whether the current tax structure is able to generate sufficient and sustainable revenues to fund government's current and future expenditure priorities.

2) The impact of the tax system in the promotion of small and medium size businesses. An analysis of tax compliance costs, the possible further streamlining of tax administration and simplification of tax legislation.

3) A review of the corporate tax system with special reference to:

   a. the efficiency of the corporate income tax structure;

   b. tax avoidance (e.g. base erosion, income splitting and profit shifting, including the tax bias in favour of debt financing);

   c. tax incentives to promote developmental objectives

   d. average (and marginal) effective corporate income tax rates in the various sectors of the economy.

4) As noted in the 2013 Budget Review, the committee will consider

   a) Whether the current mining tax regime is appropriate, taking account of:

      (i) the agreement between Government, Labour and Business to ensure that the mining sector contributes to growth and job creation, remains a competitive investment proposition and all role players contribute to better working and living conditions

      (ii) the challenges facing the mining sector, including low commodity prices, rising costs, falling outputs and declining margins as well as its current contribution to tax revenues.

   b) Various elements of taxation within the financial sector, namely the taxation regime of long term insurers (BR, page 55), the taxation of hedge funds (BR, page 56), the taxation of various innovative financial instruments (BR, page 63), and the VAT treatment of financial services and VAT apportionment within the financial sector (BR, page 63).

5) Value added tax with specific reference to efficiency and equity. In this examination, the advisability and effectiveness of dual rates, zero rating and exemptions must be considered.

6) The impact of e-commerce (especially the use of digital delivery of goods and services) upon the integrity of the tax base, in particular upon value added tax and corporate income tax revenues.

7) The progressivity of the tax system and the role and continued relevance of estate duty to support a more equitable and progressive tax

system. In this inquiry, the interaction between capital gains tax and the estate duty should be considered.

8) An evaluation of proposals to fund, for example, the proposed National Health Insurance (NHI) and long term infrastructure projects to boost the growth potential of this economy.

9) An evaluation of the legislative process with a view to both enhancing simplicity and ensuring the protection of the tax base and to recommend how to improve the current process.

The Committee is mandated to study any further tax issues which, in the Committee's view, should be addressed in order to promote inclusive economic growth, employment creation, development and fiscal sustainability. The Committee is required to submit interim reports and a final report which will be published on dates to be determined after consultation between the Committee and the Minister of Finance.

3. Objectives of South African tax system

The committee should take into account the following broad tax policy objectives:

a) Revenue-raising to fund government expenditure is the primary objective of taxation.

b) Social objectives, building a cohesive and inclusive society can be met partially through a progressive tax system and by raising revenue in order to redistribute resources.

c) Market failures can be corrected by applying a tax on production and/or consumption to internalise negative externalities, e.g. pollution or consumption of harmful products.

d) The tax system can influence behavioural changes by encouraging certain actions (e.g. savings) and discouraging others (e.g. smoking).

e) Taxes and tax incentives are sometimes used in targeted ways to encourage higher levels of investment to help facilitate economic growth.

f) International competitiveness is important, although the tax system is not the main driver of international competiveness. Innovation and productivity improvements are far more important. We should guard against the 'race to the bottom' in our efforts to strive for a "competitive tax system".

4. Background to the Review

Resulting from the last tax commission (The Katz Commission), South Africa's tax system and tax administration have undergone significant changes. An independent tax administration, the broadening of the tax base and the lowering of marginal tax rates have all contributed towards a relatively robust and competitive tax system.

Today South Africa's tax policy and tax administration compares favourably with that in many developed and emerging economies.

Given the pace of globalisation, the relatively modest economic growth following the 2008/09 economic recession and significant social challenges such as persistent unemployment, poverty and inequality, there is a need to review the contribution of the tax system (as part of an coherent and effective fiscal policy framework) in order to address these challenges in the future. There is also a need to address concerns about base erosion and profit shifting, especially in the context of corporate income tax, as identified by the OECD and G20.

ANNEXURE 2: CIT INCENTIVES

South Africa offers a range of tax and non-tax incentives. The CIT incentives mainly take the form of deductions or allowances, although incentives through exemptions are also to be found. These incentives are listed in the table below.

Type of incentive	Description of incentive/Comment	Tax policy intent relating to enactment of Incentive
Headquarters Company **Section 9I**	A company which has successfully elected into the incentive will qualify for the following: • Exemption from dividends tax; • Relief from transfer pricing; • Relief in respect of back-to-back loans and royalties.	During the 2010 Budget Speech Government announced its plan to introduce tax measures to enhance South Africa as a viable location from which business can expand into Africa. The headquarters company regime forms part of these measures. It was introduced to remove certain barriers and promote South Africa as a regional financial centre, thereby attracting foreign investments.

Rebates, Subsidies & Exemptions: Government grants & scrapping payments **Section 10(1)(*y*)**	Exemptions from normal tax, certain grants or scrapping payments from the Government based on the:
	• Financial impact of exempting the payments and
	• Extent to which the scheme supports the following Government policies' priorities and objectives:
	  • Encouragement of economic growth and investment
	  • Promotion of employment creation
	  • Development of public infrastructure
	  • Promotion of public health
	  • Development of innovation and technology
	  • Provision of housing and basic services
	  • Provision of relief in the case of natural disasters.
	[See new section 12P and Schedule 11 below, which replaces section 10(1)(*y*).]
		Government grants are intended to stimulate various aspects of the economy. Section 10(1)(*y*) allows the Minister of Finance to exempt certain government grants from tax (which have been approved in terms of the national annual budget process) by way of notice in the *Government Gazette*.

Rebates, Subsidies & Exemptions: Rebate & other assistance in respect of export finance schemes **Section 10(1)(*z*A)**	The section currently provides that where a scheme for the promotion or financing of exports is approved by the Minister of Trade and Industry with the concurrence of the Minister of Finance, any amount received by or accrued to an exporter by way of a rebate or other assistance will be exempt from normal tax.	The policy position is unclear (the section was introduced in the 1970's): however, it appears that the section was introduced in an apparent drive to support export oriented industries during the 1970's.
Rebates, Subsidies & Exemptions: Films **Section 10(1)(*z*G)**	Exempts from normal tax any amount paid by way of subsidy that is designed to promote the production of films (as defined in S24F). [See new section 12O (discussed below) effective as from 1 January 2012.]	Section 10(1)(*z*G) was introduced as part of an incentive to encourage the development of films produced in South Africa. This section applied up to 31 December 2011.

Deductions in respect of the acquisition of intellectual property: Invention, patent, design, copyright, or other property of a similar nature **Section 11(*g*C)**	• Provides for an allowance for expenditure actually incurred to acquire: an invention or patent, design, copyright; other property of a similar nature; or knowledge essential for the use of such patent, design, copyright or other property or the right to the imparting of such knowledge. In the case where expenditure actually incurred exceeds R5000, the allowance in any year of assessment is limited to: • 5% of the amount of the expenditure, essential for the use of such property; or • 10% of the amount of expenditure in respect of any design or other property of a similar nature or knowledge essential for the use of such design or other property or the right to have such knowledge imparted.	In general, the rationale for the provision is to encourage the development of intellectual property and the use of such property while at the same time to discourage abuse of the legislation.
Deductions: Scientific & Technological Research and Development **Section 11D**	New Section 11D: provides for two types of deductions: • A 100% deduction on expenditure actually incurred on research and development; undertaken in the Republic and incurred in the production of income; and in the carrying on of any trade. • A 50% uplift on research and development approved by the Department of Science and Technology.	Section 11D was introduced to encourage innovation, research and development in science and technology. Improvement in these areas is regarded as key to improving productivity, which in turn leads to increased economic growth, international competitiveness and new or improved products, processes or services.
Farming & Renewable Energy Relief: Machinery, implement, utensil or article, owned by the taxpayer and used in farming or the production of renewable energy **Section 12B**	The deduction is calculated on the cost of the asset at the rate of: • 50% of the cost in the year during the asset is brought into use • 30% in the second year; and • 20% in the third year. Where the machinery, plant, implement, utensil, or improvements are mounted on or affixed to any concrete or other foundation or supporting structure, the foundation or supporting structure is deemed to be part of the assets for the purposes of this deduction.	Section 12B was originally inserted in the Act to give effect to the recommendations of the Margo Commission. The aim is to give accelerated write-offs to certain sectors of the economy to reduce the cost of acquiring certain assets. In addition to farming, the following two industries were also added in later years in an effort to encourage investment: • Production of bio-diesel or bio-ethanol • Generation of electricity from wind, sunlight, gravitational water forces etc.
Deduction in respect of assets used by manufacturers or hotel keepers or in respect of aircraft and ships, and in respect of	The deduction is equal to: • 40% in the year in which the asset was brought into use; and • 20% in each of the three subsequent years of assessment. Where the machinery, plant, implement, utensil, or improvements are mounted on or affixed to any concrete or other	In line with the Margo commission recommendations section 12C was introduced, providing for an accelerated write-off period of five years for certain assets (20% straight-line) such as hotels, ships, aircraft, machinery used for section 11D research & development, as well as improvements

assets used for storage and packing of agricultural products. **Section 12C**	foundation or supporting structure, the foundation or supporting structure is deemed to be part of the assets for the purposes of this deduction.	to these assets. It was meant to serve as an incentive for investment in these particular industries. The policy rationale for providing the accelerated write offs in respect of farming, in particular, is not explicit. It is, however, presumed that such incentive has been given on account of agriculture being subject to cash flow constraints triggered by the prolonged duration between harvesting and reaping. Furthermore, this sector is vulnerable to unpredictable weather conditions which might adversely affect the farming business.
Pipelines, transmission lines and railway lines **Section 12D**	Deductions relating to: • Pipeline: used for the transportation of natural oil or used to carry water to a power station • Line or cable used for the transmission of electricity • Telephone line or cable used for the transmission of any signal for the purpose of telecommunication • Railway line used for the transportation of goods The allowance is limited, per annum, to: • 10% of the cost incurred in respect of the pipeline used to transport natural oil • 5% of the cost of the pipeline used to transport water used to generate electricity; line or cable used to transmit electricity; line or cable used to transmit electronic communications; and the railway line used to transport persons, goods or things.	Government saw the development of natural gas as an important contributing factor to the economic development of the country. The possibility of such exploration was, however, dependent on the economic viability thereof. Government also realised that the unavailability of a depreciation regime for these assets could potentially have had an adverse effect on the investment decisions of companies contemplating investment in this area. The introduction of a depreciation allowance was therefore aimed at encouraging and supporting the capital investment required for these types of projects.
Allowance for rolling stock used in the transportation of persons, goods or things **Section 12DA**	Will apply to locomotives, carriages, or other vehicles used on a railway: The 20% allowance per tax year is calculated on a “straight line” basis, providing for a five-year write off period.	With the introduction of private and semi-private players (Transnet) in the transportation of goods and passengers via rail a more favourable tax dispensation was needed (previously, since Government was the only player such incentives were not required). A vast imbalance existed between the South African transportation network capacity and the infrastructural demands of the growing South African economy. To ensure a balance between the transportation network and the status of the economy, Government decided to encourage investment in this industry, which forms a key cost item for primary product sales. In addition, the depreciation rate for rolling stock places rolling stock at a disadvantage vis-à-vis trucks. As government has an overriding objective of reducing the cost of doing business, an accelerated depreciation allowance was proposed to encourage the development of rail transport infrastructure.

Airport and Port Assets **Section 12F**	The Airport and port assets subject to the allowance include: • New and unused aircraft hangars, aprons, runways and taxiways (including supporting structures erected on a designated airport asset) • New and unused port terminals, breakwaters, berths, quay walls and shipways A 5% annual deduction of the actual cost incurred on the acquisition (including the construction, erection or installation). This is included as an incentive because this deduction would otherwise be disallowed as being capital in nature.	Historically, depreciation allowances have not been granted in respect of permanent structures. This is due to the fact that such assets have long economic life spans and investment in these types of assets has traditionally been undertaken by Government. The introduction of section 12F was carried out with a view to promoting private investment in public infrastructure. This was also in line with international trends of introducing tax allowances for pipelines for the purpose of transporting oil and gas, electricity transmission lines, telephone transmission lines and railway lines.
Deductions: Learnership agreements **Section 12H**	Section 12H provides a deduction to employers in each of the years of assessment in respect of which learnership agreements are entered into with learners, as follows: • An additional allowance of R30,000 in respect of a registered learnership agreement entered into between the learner and an employer before 1 October 2011 (apportioned where the learnership agreement is for a period of less than 12 months). • A completion allowance of R30,000 may be claimed in respect of these learnership agreements where the learner successfully completes the learnership. • In the case where a learner is a person with a disability, the additional allowance and completion allowance of R20,000 may be claimed.	This is an incentive for training employees in a regulated environment in order to encourage skills development and job creation.
Deductions: Additional investment & training allowance for Industrial Policy Projects **Section 12I**	A company carrying on a "strategic industrial project" may claim a deduction in addition to any other deductions or allowances. The quantum of the deduction is determined according to whether the project is approved with preferred status or not and is allowed in addition to any other allowances allowable in terms of the Act: • Preferred status: 75 per cent (100 per cent if the asset is part of an industrial policy project) of the cost of industrial assets in the year that the asset is brought into use, limited to the lesser of the amount invested or R900m. • Non-preferred status: 35 percent (55% if the asset is part of an industrial policy project) of the cost of industrial assets, limited to the lesser of the amount invested in industrial assets or R550m. • Additional training allowance to the company limited to R36,000 per employee, limited to R30m in the case	The main aims for the Industrial Policy framework are to: • Diversify South Africa's industrial output • Support a knowledge-based economy and nurture labour intensive industries • Increase productivity in the manufacturing sector • Transform production processes and methods to attain cost reductions and greater efficiencies with regards to the use of resources In support of these aims an incentive programme is required to (embodied in section 12I): • Assist this transformation by supporting investment in manufacturing assets that will improve the productivity of the South African manufacturing sector and • Concurrently with and complementary to this, support should be given to

	of an industrial project with preferred status and R20m in the case of a project with non-preferred status.	training of personnel to improve labour productivity and the skills profile of the labour force.
Exemption for Certified Emission Reductions: Exemption on disposal of certified emission reductions (CERs) **Section 12K**	Provides for full exemption from tax of any amount received by or accrued to or in favour of any person in respect of the disposal by such person of any certified emission reduction (CER) derived by that person in the furtherance of a qualifying Clean Development Mechanism project (CDM). The exemption only applies to disposals off-shore, and was meant to be an interim measure.	The South African Government fully recognises that climate change is a global environmental market failure that requires a considered international and domestic policy response. The global nature of climate change arises from the fact that a ton of carbon emitted anywhere in the world (by developing or developed countries) has the same effect on temperatures globally. South Africa's greenhouse gas emissions rank within the top 20 in the world, contributing 1.8 per cent to global emissions, and are responsible for 42% of Africa's emissions (primarily due to South Africa's heavy reliance on coal for electricity and its extensive use of motor vehicles versus other forms of transport). In terms of tax, the disposal of CERs is largely untested, thereby creating further uncertainty for CDM projects. The default interpretation is to treat the disposals of CERs as ordinary revenue from trading stock. While this tax result could theoretically be applied, taxation of CERs at full ordinary rates will add a prohibitive cost for otherwise marginal CDM projects, given their high financial hurdle rates. Hence, as part of South Africa's domestic policy response to climate change, tax relief is required to overcome the market failure associated with environmental protection.
Energy efficiency savings: Allowance **Section 12L**	Provides for a deduction of an allowance in respect of energy efficiency savings in terms of a specific formula, as follows: $A = \frac{B \times C}{D}$ A = deduction allowed (to be calculated) B = energy efficiency savings (kilowatt hour) C = applied rate (Rand value per kilowatt hour) – currently 45 cents D = 2 A deduction is allowed where the taxpayer has submitted a certificate issued by an institution, board or body prescribed in the regulations.	Given the need to address the challenges relating to climate change and to improve energy use, it has become necessary to find ways to improve energy efficiency. Energy efficiency savings can be viewed as one of the "low-hanging fruits" to help address the concerns relating to climate change and energy security. In this context the conversion by taxpayers of old technologies to new ones often involves a substantial amount of capital expenditure. The perceived long pay-back period tends to discourage business from making upfront investments relating to energy efficiency savings. Given the contribution that energy efficiency savings can make towards a reduction in the demand of energy (especially electricity) and resulting reduction in CO_2 emissions (taking into account the fossil fuel intensive nature of energy

		production in South Africa), it is deemed appropriate to encourage greater levels of energy efficiency savings.
Exemptions in respect of films **Section 12O**	Provides for exemption from normal tax of receipts and accruals of income derived from exploitation rights of a film.	An incentive under section 12O was introduced to remove the accelerated write-off in section 24F and continue to incentivise the development of South African films. The film incentive under section 24F was in many respects unsuccessful and widely abused by taxpayers. This meant that taxpayers were often more concerned with maximising tax benefits rather than having regard for the underlying film. In view of this, the new incentive under section 12O was introduced in a transformed manner that encouraged profit making as opposed to generating expenditure.
Exemption of amounts received or accrued in respect of government grants **Section 12P**	Provides for exemption of government grants if: • These are listed in the 11th Schedule; or • Are identified by the Minister by notice in the *Government Gazette*	Most Government grants to the private sector are intended to stimulate various aspects of the economy; some assist groups in distress while others induce an otherwise non-economic activity. The Income Tax Act contains various provisions that exempt certain Government grants. However, these rules are scattered and often lack policy direction. While policy criteria exist which function as grounds for the Minister to provide exemption by way of notice, most of these criteria are not strongly enforced. On the other hand taxing grants is questionable as a policy, because most grant recipients do not expect the grants received to be taxed, as this is viewed as partial withdrawal of the grant promised. A revised approach provides for a comprehensive list of exempted grants which will be published and updated annually. The Minister of Finance will retain the power to exempt grants by way of a notice so that in urgent circumstances, exemptions pertaining to grants are not unduly delayed by lengthy parliamentary timeframes.
Deductions in respect of buildings used wholly or mainly in a process of manufacture **Section 13(1)**	This incentive provides for a deduction if the building was used by the owner in the manufacturing process, research and development, or let to a tenant. The allowance is as follows: If building commenced: • Between 14 March 1961 and 1 January 1989 - 2% per annum; • On or after 1 January 1989 but before 1 July 1996 (or improvements) - 5% per annum; • On or after 1 July 1996 until 30 September 1999 (including	Government recognises that buildings used for the purpose of manufacturing have a reduced lifespan. From a policy perspective Government wishes to support the manufacturing industry. This section is aimed at reducing costs incurred in constructing; refurbishing and improving buildings used in the process of manufacture and, in an effort to incentivise, an increase in manufacturing capacity in SA was made applicable to new buildings.

	improvements) -10% per annum; • On or after 1 October 1999 (including improvements) - 5 % of cost per annum. Similar allowances are permitted to persons who purchase buildings, whether a new or old one.	
Hotel keepers **Section 13*bis***	An annual allowance on the cost of the portion of buildings or improvements used mainly for carrying on the trade of hotel keeper is provided as follows: • Post 1 July 1965 – annual allowance of 2%; • Post 4 June 1988 – annual allowance of 5%; • Post 4 June 2004 – 10% annual allowance.	In terms of existing legislation, the cost of new hotel buildings or of improvements to existing buildings could be written off at a rate of 5 per cent per annum. To maintain requisite standards, hotels are subject to regular refurbishment, and it is often difficult to classify the work done to buildings as improvements, repairs or the acquisition of new equipment. The fact is that the benefit to the hotel owner endures only until the date of the next refurbishment. To recognise this fact this section allows for accelerated depreciation periods, as opposed to long term write off periods generally associated with immovable property.
Urban Development Zones (UDZ): Deductions for the erection of or improvements to buildings in UDZs **Section 13*quat***	The incentive is available for the erection or improvement of commercial or residential buildings in areas in need of urban renewal. The incentive only applies to buildings erected or improvements carried out within demarcated areas, referred to as UDZ. The UDZ allowance takes the form of both additional and accelerated depreciation allowances. Depending on the nature of the erection or improvement, such allowance can be as high as 25% per annum on the cost of such erection or refurbishment.	Under current law, the tax depreciation of buildings is generally matched to the useful life thereof (or slightly shorter), being nil, 2% or 5%. No provision exists for the accelerated tax depreciation of buildings. Similar to many countries, South Africa has a number of urban areas that are impoverished and suffering from extensive urban decay. In order to address these concerns and maintain existing infrastructure that was developed at great cost, governments internationally have utilised tax measures to support efforts aimed at regenerating these urban areas. These narrowly targeted capital allowances seek to attract private sector businesses to areas where interest would otherwise be lacking. The legislation was therefore introduced as a response, in the form of an accelerated depreciation allowance for investments in the inner cities. The core objectives of the incentive are to promote urban renewal and development by promoting investment by the private sector in the construction and improvement of buildings.
Commercial buildings **Section 13*quin***	This incentive provides for an annual allowance on the cost of any new and unused buildings owned by the taxpayer if: • The building is wholly or mainly used by the taxpayer during the year of assessment; and • For the purposes of producing income	Buildings and other permanent structures depreciate in value during their useful life spans. Accounting practice reflects this by providing for an annual depreciation allowance for all buildings and permanent structures, irrespective of the business nature for which these assets are used. In keeping

	in the course of the taxpayer's trade The allowance is equal to: • A 5% annual allowance to the extent that the taxpayer acquires a part of a building without erecting or constructing that part, if the building or improvement is wholly or mainly used by the taxpayer during the year of assessment for the purpose of trade, excluding the provision of accommodation. • 55% of the acquisition price, in the case of a part being acquired; and 30% of the acquisition price, in the case of an improvement being acquired, and is deemed to be the cost incurred by the taxpayer in respect of that part or improvement, as the case may be.	with accounting practice, there was therefore no reason for the tax system to exclude commercial buildings from wear and tear allowances provided for in the Act. The continued denial of depreciation for certain buildings and structures raised the carrying cost of doing business without any meaningful policy rationale.

Building allowance relating to low cost housing
Section 13*sex*
	• Provides for an additional allowance of 5% of the cost of a low-cost residential unit
	• To the extent that the taxpayer acquires a residential unit representing only a part of a building without erecting or constructing that unit or improvement —
	  • 55% of the acquisition price in the case of a unit being acquired; and
	  • 30% of the acquisition price in the case of the improvements being acquired,
	is deemed to be the cost incurred by that taxpayer in respect of that unit or improvement, as the case may be.
		The construction and provision of low-cost housing posed a serious challenge to the construction industry. While government was making a great deal of effort to overcome this, the introduction of an additional allowance under section 13*sex* to give support to construction of low-cost housing was necessary.

Low-cost residential units: Deduction in respect of sale of certain low-cost residential units on loan account **Section 13*sept***	Where a company disposes of a low-cost residential unit to an employee on a loan account it may, for a 10 year period, claim a deduction equal to 10% of the amount outstanding at the end of the year of assessment in respect of these disposals.	Given the inherent risks in the property market, the construction and provision of low-cost housing poses a unique challenge within the domestic environment. While Government has put many outreach programmes in place to overcome these challenges, further support for low-cost housing in a tax environment could prove beneficial.
Mining tax: Deduction of expenditure of a capital nature **Sections 15 & 36**	Companies involved in mining are allowed a deduction for "capital expenditure" (as defined) incurred, but this must not result in an assessed loss. The balance of any unredeemed capital expenditure is carried forward and may be set-off against future mining income.	Special relief for companies involved in mining in order to incentivise high-risk capital intensive mining expenditure & investment with long payback periods. It also avoids the need for complicated loss carry-back provisions used in other jurisdictions.
Farming relief: Construction of soil erosion works – lessor of land for farming purposes **Section 17A**	The section is aimed at the lessor of land for farming purposes and allows for the deduction of expenditure incurred in respect of the construction of soil erosion works on the land. The deduction is limited to taxable income (i.e. may not create a loss), but the balance may be carried forward to the succeeding year. The relief is conditional on the taxpayer submitting a certificate issued by the Executive Officer designated under section 4 of the Conservation of	The section was introduced as part of the general concession for the construction of soil erosion works available to farmers, and is meant to incentivise owners and lessors of land for farming purposes to protect against soil erosion.

	Agricultural Resources Act, 1983.	

Film allowance: Allowance in respect of films **Section 24F**	The incentive is aimed at "production costs" (PC) and "post production costs" (PPC) (as defined) actually incurred by the film owner in connection with any film used in the production of income, as follows:
	• Total amount of PC and PPC:
	  • If at least 75% of the total amount incurred was paid or payable in the Republic in respect of services rendered or goods supplied in the Republic; or
	  • Where the film is a co-production in terms of an agreement between SA and another government.
	• As much of the PC and PPC as was paid or payable in the Republic in respect of services rendered or goods supplied in the Republic.
	Where any cost is not deductible in terms of the above, a deduction of 10% per annum is allowed as from the year in which the completion date of the film falls (and the succeeding nine years).
	[Note: this incentive is being phased out – to be replaced by section 12O]]
		The film allowance was introduced to encourage the production of South African films and hence encourage domestic creativity and promote South African culture. The deduction has the secondary aim of stimulating domestic spending since it only applies to costs incurred / payments made in the Republic.
		This incentive was limited over time due to the widespread abuse taking place.

Farming relief: Replacement livestock Section 26 and the 1st Schedule (par 13)	Where a farmer sells livestock due to drought, disease, plague or damage to grazing due to fire, or as part of a livestock reduction scheme organised by Government, the farmer may elect that the cost of the replacement livestock be deducted (where replaced within four years after event) in the year of the forced sale (and not in the year of replacement).	Relief measures for farmers are generally used to enhance fairness, or as relief measures during disruptive weather climatic conditions, such as droughts and floods, but can also be used to pursue various Government policy objectives (such as food security and employment creation).
Farming relief: Drought relief Section 26 and the 1st Schedule (par 13A)	Proceeds received by a farmer from the sale of his livestock on account of drought will not form part of the farmer's gross income (elective provision) insofar as the proceeds (or portion thereof) are deposited with the Land Bank within 3 months of receipt.	Paragraph 13A of the First Schedule provides relief for farmers against negative natural events caused by weather such as drought. It recognises the vulnerability of this sector to the adverse consequences of unforeseen and uncontrollable weather forces.

Capital Gains Tax: Partial inclusion of capital gains **Section 26A and the 8th Schedule (par 10)**	Taxable capital gain: 80% of the net capital gain is taxable by way of inclusion in taxable income – compared to a full inclusion of revenue items. The maximum effective capital gains tax rate for companies is 22.4%. The inclusion rate for individuals is 40% with a maximum effective capital gains rate of 16,4%. The annual amount above which capital gains become taxable for individuals is R40 000.	Various factors were considered by National Treasury in charging a lower rate for capital gains as compared to revenue gains. Amongst such factors militating for a lower inclusion rate was that the CGT legislation makes no compensation for inflationary gains; a low inclusion rate to some extent compensates for this. Other factors justifying a rate for capital gains lower than revenue rates are that capital is often relatively mobile; accordingly it was felt prudent not to introduce a CGT charge which would encourage movement of capital outside the jurisdiction of the South African tax net.
Oil & gas companies: Specific provisions for oil & gas companies **Section 26B & 10th Schedule**	Fiscal stability agreements (FSA): The Minister may enter into FSAs with any oil and gas company in order to guarantee the rates and incentives contained in the 10th schedule of the Act (as at the date of signature) for as long as the oil and gas right is held by that company. Income tax: Oil and gas companies may deduct from their oil and gas income: • All expenditure and losses actually incurred in respect of exploration and production (of whatever nature) • Additional 100% of their expenditure of a capital nature actually incurred in respect of exploration • Additional 50% of their expenditure of a capital nature actually incurred in respect of production [In other words, expenditure of a capital nature qualifies for a double deduction in respect of exploration, and for a 150% deduction in respect of production.] Dividends tax (DT): DT payable on amounts distributed out of amounts attributable to oil and gas income is reduced (from 15%) as follows: • 5% - oil and gas rights generally • 0% - oil and gas rights are solely derived (directly or indirectly) by virtue of an OP26 right	South Africa's present investment regime for oil and gas exploration and production was established in terms of prospecting lease OP26 (granted in 1965). The OP26 agreement contains fiscal stabilisation clauses that freeze the Income Tax Act as of 1977. The net result is that oil and gas companies have a choice in terms of each provision of the tax acts – choose the 1977 regime or the current regime (whichever the oil and gas company views as more favourable). This fiscal stabilisation regime acts as an incentive to invest in "high risk" exploration activities that require substantial upfront capital investment. While South Africa is rich in many hard minerals, the country has not shared the same success in respect of oil and gas reserves. Exploration over the past thirty years has revealed only small deposits offshore in the South and in the West (all of which are small in comparison to both global and regional standards). However, a few companies remain interested in the region.
Co-operative trading societies and companies: Deduction for bonuses & allowance **Section 27**	Bonuses deductible: Co-operative trading societies and agricultural co-operatives (as defined in the Co-operative Societies Act, 1939) may deduct from their income bonuses distributed to members (certain limitations apply based on the value of trade with members). Allowance for storage buildings: An allowance may be deducted from income equal to 2% of the cost of buildings erected by the co-op (including any improvements affected) used wholly or mainly for storage (unless allowed under section 13(1) or 11(*g*)). Any recoupments	Recognises the principle of mutuality which in essence acknowledges that it is necessary for people to work in groups to leverage the higher capital base typically available to groups than to individuals..

	under section 8(4)(*a*) in respect of this allowance may, at the option of the co-op, be allocated to the cost of erecting a replacement building. Amalgamated co-ops: Treated as one and the same for tax purposes.	
Mining closure rehabilitation company / trust: Exemption for specially formed mining rehabilitation funds **Section 37A**	Deduction for cash paid to: a company / trust whose sole object is to apply its property for the decommissioning, closure, rehabilitation or restoration of any latent or residual environmental impact and/or to land use which conforms to the generally accepted principle of sustainable development. Exempt income / growth: Provided the rehabilitation company / trust holds only of the prescribed assets its income, any growth in assets is exempt from tax. (Note: previously dealt with in section 10(1)(*c*H) and 11(*h*A))	In terms of the Mineral and Petroleum Resources Development Act of 2002 (MPRDA), mining companies must make financial provision for the environmental rehabilitation of mining areas upon closure. Methods used for financial provision include reserves set aside within a rehabilitation company, society, association or trust (i.e. a rehabilitation fund). Contributions to these funds are deductible, and the growth in these funds is tax-free. The tax system provides these benefits as an incentive for environmental preservation. Section 37A combines the mining rehabilitation fund contribution rules previously contained in section 10(1)(*c*H) and 11(*h*A), and clarifies the limits involved. There is no change in policy; contributions to mining rehabilitation funds remain deductible and growth in these funds remains exempt.

Environmental expenditure: Allowance & deduction for environmental assets
Section 37B
	• An allowance for environmental assets may be deducted, as follows:
	  • Environmental treatment and recycling assets (new and unused): 40% in the year in which the asset is brought into use, and 20% for the succeeding three years.
	  • Environmental waste disposal asset (new and unused) : 5% per year
	• Post trade expenses and losses: Deduction of any expenditure or loss in respect of the decommissioning, remediation or restoration arising from any trade carried on previously by the taxpayer insofar as it was incurred for purposes of complying with any law that provides for the protection of the environment.
		Much of the tax law predates awareness of environmental issues. Prior to the introduction of this section, certain permanent environmental capital expenditures relating to manufacturing were granted depreciation relief under the Act, while other permanent comparable expenditures were not. In addition, questions exist as to the deductibility of environmental costs incurred after closure of a trade (such as decommissioning, remediation and restoration costs) which would generally not be deductible. As a policy matter, environmental capital expenditure of a permanent nature should be entitled to some level of depreciation, even though only ancillary to the process of manufacture. Environmental capital expenditure is a legal precondition for operation and should be encouraged as a matter of sound government policy. Therefore, a new regime for environmental capital expenditure of a permanent nature was proposed. [It should be noted that no regime is necessary for environmental moveable equipment because such equipment is depreciable like any other moveable equipment used to carry on a trade (see section 11(e))]. Post-trade

		environmental expenses should similarly be granted relief. These expenses are not optional.

Environmental conservation and maintenance: Deductions allowed
Section 37C
	• Deduction for expenditure actually incurred to conserve or maintain land, as follows:
	  • Where a biodiversity management agreement (in terms of section 44 of the Biodiversity Management Act) covering a period of at least five years exists (expenditure is deemed to be incurred in the production of income and for purposes of a trade carried on). However, this may not create a loss but may be carried forward for deduction in the subsequent year (ring-fenced to trade conducted on the land).
	  • Where the expenses are incurred in respect of a declaration (in terms of section 20, 23 or 28 of the Protected Areas Act) that has a duration of at least 30 years (expenditure is deemed for the purposes of section 18A to be a donation paid/transferred to the Government for which a receipt has been issued).
	• Deduction of 10% per year of the lesser of the cost / market value of the land (deemed for the purposes of section 18A and par 62 of the Eighth Schedule to be a donation paid/transferred to the Government for which a receipt has been issued) starting from the year in which the land is so declared (and the next nine years) where the land is declared a national park or national reserve in terms of section 20(3) or 23(3) of the Protected Areas Act and the declaration is endorsed on the title deed with a duration of at least 99 years.
		In an effort to preserve nature and the environment, Government (through the Department of Environmental Affairs and Tourism) created a system for entering into bilateral agreements with private landowners to conserve and maintain particular areas of land for the public good. The legislative framework for these agreements comprises the National Environmental Management: Protected Areas Act and the National Environmental Management Biodiversity Management Act, both of which are laws for determining the geographic areas of land and biological systems to be protected or conserved. Private landowner entry into any of these agreements is wholly voluntary.

Tax holiday scheme: Companies involved in approved manufacturing projects **Section 37H**	• Certain approved manufacturing businesses meeting certain investment criteria, will receive a tax holiday for two to six consecutive years, depending on which requirements they meet (in the spatial, industry and human resources components). The effect of this is that no tax (normal tax or STC) is payable by these companies during the tax holiday period.	Tax holidays have fallen into disrepute as an industrial policy incentive and are being phased out, largely having been superseded by section 12I and its predecessor section 12G (both sections 12G and 12I pertain to industrial incentives). The phasing out of this type of incentive was done in order to utilise a more structurally sound method of tax incentive, whereby expenditure is incentivised as opposed to exempting income. Tax holidays were open to abuse, in particular in instances where companies which were granted tax holiday status were used to shield loss making entities within the same group of companies. Furthermore, companies using tax holidays were often accused of being "footloose" in the sense that they would make low level investments during the period in which the tax holiday was available and thereafter would move their investments to other jurisdictions with more favourable tax incentives.

Source: SARS 2013 CIT Product Report

Note: The above table reflects the position as at the promulgation of the Taxation Laws Amendment Act, 2012.

ANNEXURE 3: INTERNATIONAL COMPARISON OF CIT RATES, 2015

Country	Rate		Country	Rate
United Arab Emirates	55		Tunisia	25
United States	40		Uruguay	25
Argentina	35		Korea, Republic of	24.2
Zambia	35		Denmark	23.5
India	34.61		Chile	22.5
Brazil	34		Botswana	22
Venezuela	34		Ecuador	22
Belgium	33.99		Slovakia	22
France	33.33		Sweden	22
Japan	33.06		Syria	22
Pakistan	33		Vietnam	22
Mozambique	32		Portugal	21
Italy	31.4		Armenia	20
Angola	30		Croatia	20
Australia	30		Estonia	20
Costa Rica	30		Iceland	20
Mexico	30		Jordan	20
Nigeria	30		Russia	20
Peru	30		Thailand	20
Philippines	30		Turkey	20
Uganda	30		United Kingdom	20
Germany	29.65		Yemen	20
New Zealand	28		Czech Republic	19
South Africa	**28**		Hungary	19
Spain	28		Poland	19
Sri Lanka	28		Belarus	18
Bangladesh	27.5		Ukraine	18
Dominican Republic	27		Switzerland	17.92
Norway	27		Singapore	17
Canada	26.5		Taiwan	17
Israel	26.5		Hong Kong SAR	16.5
Greece	26		Mauritius	15
Zimbabwe	25.75		Ireland	12.5
Austria	25		Paraguay	10

Country	Rate		Country	Rate
China	25		Qatar	10
Colombia	25		Bahamas	0
Guatemala	25		Bahrain	0
Jamaica	25		Bermuda	0
Malaysia	25		Cayman Islands	0
Netherlands	25		Guernsey	0
Panama	25		Isle of Man	0

Source: KPMG International, Corporate and Indirect Tax Survey 2015

Regional average	2006	2010	2015
North America average	38.05	35.50	33.25
Africa average	30.82	28.38	28.03
Oceania average	30.60	29.00	27.00
Latin America average	29.07	27.52	26.61
OECD average	27.67	25.70	24.77
GLOBAL AVERAGE	**27.50**	**24.69**	**23.68**
EU average	24.83	22.93	22.15
Asia average	28.99	23.96	21.91
Europe average	23.70	21.46	20.24

Source: KPMG International, Corporate and Indirect Tax Survey 2015

ANNEXURE 4: INTERNATIONAL COMPARISON OF PIT & VAT/GST RATES, 2014

Countries	Top marginal Personal Income Tax rate	VAT/GST rate
Afghanistan	20.00	10.00
Albania	23.00	20.00
Algeria	35.00	17.00
Angola	17.00	10.00
Argentina	35.00	21.00
Armenia	26.00	20.00
Aruba	59.00	1.50
Australia	45.00	10.00
Austria	50.00	20.00
Azerbaijan	25.00	18.00
Bangladesh	25.00	15.00
Barbados	35.00	17.50
Belarus	12.00	20.00
Belgium	53.70	21.00
Bolivia	13.00	13.00
Bosnia and Herzegovina	10.00	17.00
Botswana	25.00	12.00
Brazil	27.50	19.00
Bulgaria	10.00	20.00
Cambodia	20.00	10.00
Canada	29.00	5.00
Chad	60.00	18.00
Chile	40.00	19.00
China	45.00	17.00
Colombia	33.00	16.00
Congo	30.00	13.00
Costa Rica	15.00	13.00
Croatia	47.20	25.00
Cyprus	35.00	19.00
Czech Republic	22.00	21.00
Denmark	55.60	25.00
Dominican Republic	25.00	18.00
Ecuador	35.00	12.00
Egypt	25.00	10.00
El Salvador	30.00	13.00
Equatorial Guinea	35.00	15.00
Estonia	21.00	20.00
Ethiopia	35.00	15.00
Euro area	44.50	20.67

Countries	Top marginal Personal Income Tax rate	VAT/GST rate
Fiji	20.00	15.00
Finland	51.50	24.00
France	50.30	20.00
Gabon	35.00	18.00
Georgia	20.00	18.00
Germany	47.50	19.00
Ghana	25.00	15.00
Greece	46.00	23.00
Guatemala	7.00	12.00
Guinea	40.00	18.00
Honduras	25.00	15.00
Hungary	16.00	27.00
Iceland	46.22	25.50
India	33.99	12.36
Indonesia	30.00	10.00
Ireland	48.00	23.00
Isle of Man	20.00	20.00
Israel	50.00	18.00
Italy	47.90	22.00
Ivory Coast	60.00	18.00
Jamaica	25.00	16.50
Japan	50.84	8.00
Jordan	14.00	16.00
Kazakhstan	10.00	12.00
Kenya	30.00	16.00
Latvia	24.00	21.00
Lebanon	20.00	10.00
Liechtenstein	21.00	8.00
Lithuania	15.00	21.00
Luxembourg	43.60	15.00
Macedonia	10.00	18.00
Madagascar	20.00	20.00
Malawi	30.00	16.50
Malaysia	26.00	6.00
Malta	35.00	18.00
Mauritania	33.00	18.00
Mauritius	15.00	15.00
Mexico	30.00	16.00
Moldova	18.00	20.00
Mongolia	10.00	10.00
Montenegro	9.00	19.00
Morocco	38.00	20.00
Mozambique	32.00	17.00
Namibia	37.00	15.00

Countries	Top marginal Personal Income Tax rate	VAT/GST rate
Netherlands	52.00	21.00
New Zealand	33.00	15.00
Nicaragua	30.00	15.00
Nigeria	24.00	5.00
Norway	39.00	25.00
Panama	25.00	7.00
Papua New Guinea	42.00	10.00
Peru	30.00	18.00
Philippines	32.00	12.00
Poland	32.00	23.00
Portugal	56.50	23.00
Republic of The Congo	45.00	18.00
Romania	56.50	24.00
Russia	13.00	18.00
Rwanda	30.00	18.00
Senegal	40.00	18.00
Serbia	15.00	20.00
Seychelles	15.00	15.00
Sierra Leone	30.00	15.00
Singapore	20.00	7.00
Slovakia	25.00	20.00
Slovenia	50.00	22.00
South Africa	40.00	14.00
South Korea	38.00	10.00
Spain	52.00	21.00
Sri Lanka	24.00	12.00
Sudan	15.00	10.00
Suriname	38.00	10.00
Swaziland	33.00	14.00
Sweden	56.90	25.00
Switzerland	40.00	8.00
Taiwan	40.00	5.00
Tanzania	30.00	18.00
Thailand	35.00	7.00
Trinidad and Tobago	25.00	15.00
Tunisia	35.00	18.00
Turkey	35.00	18.00
Uganda	40.00	18.00
Ukraine	17.00	20.00
United Kingdom	45.00	20.00
United States	35.00	0.00
Uruguay	30.00	22.00
Uzbekistan	22.00	20.00
Venezuela	34.00	12.00

Countries	Top marginal Personal Income Tax rate	VAT/GST rate
Vietnam	35.00	10.00
Yemen	15.00	2.00
Zambia	35.00	16.00
Zimbabwe	50.00	15.00

Sources:

http://www.tradingeconomics.com/country-list/personal-income-tax-rate

http://www.tradingeconomics.com/country-list/sales-tax-rate