Sector Study of the Effective Tax Burden

South Africa

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### SUMMARY OF ACRONYMS

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<th>Acronym</th>
<th>Full Form</th>
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<tr>
<td>DFID</td>
<td>Department for International Development</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>GSA</td>
<td>Government of South Africa</td>
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<tr>
<td>IDZ</td>
<td>Industrial Development Zones</td>
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<td>METR</td>
<td>Marginal Effective Tax Rate</td>
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<td>SARS</td>
<td>South Africa Revenue Service</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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This report forms part of a multi-country study of African revenue authorities being undertaken by FIAS in collaboration with the United Kingdom Department for International Development (DFID). The purpose of the study series is to determine whether the tax policy and tax administration regimes are conducive to economic growth. A key focus is on the opportunities created by bringing informal firms into the tax net and appropriate tax policies for small enterprises. FIAS undertook a pilot study of Zambia, published in December 2004.¹

On behalf of the Government of South Africa, the National Treasury, in conjunction with the South African Revenue Service, requested that FIAS conduct a similar study of the effective tax burden on five key sectors in the South African economy. The purpose was to investigate whether these sectors are competitive domestically and internationally, as regards the impact of the tax regime. This study provides the government with information it seeks through use of marginal effective tax rate calculations carried out in each of the identified sectors, and through qualitative analysis about the appropriateness of the tax/incentive scheme undertaken by sector experts. It also offers cross-country analysis allowing the assessment of international competitiveness. A third component built into this study is a capacity building exercise, with the group of international consultants tasked to work closely with a National Treasury and South African Revenue Service counterpart group to transfer the knowledge and methodology underlying such an analysis.

¹ The Swedish Agency for International Development co-funded the Zambia study.
## Summary of Key Issues and Recommendations

<table>
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<th>Issues</th>
<th>Recommendations</th>
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<td><strong>General Economy</strong>: The tax system is broadly appropriate and conducive to growth of the five sectors. Tax issues are second order.</td>
<td>• Avoid significant changes to the tax code, which would create uncertainty in the private sector.</td>
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**Small businesses (METR 0% - 29%)**
Formal, registered small businesses benefit from tax concessions. Very small, often informal, businesses face a high METR.

- Set up a Small Taxpayer Unit with a remit to bring small businesses, many of whom are currently informal, into the tax net.
- Expand education and outreach to facilitate formalization and full compliance.

**Agriculture Sector (METR 5.7%)**: Currently pays very little tax. Faces uncertainty over municipal taxation.

- Regulate the Municipal Rates Property Act to generate certainty.
- Reduce the number of ad hoc exemptions.

**Manufacturing Sector (METR 21.3%)**
Few sector wide incentives. But several industry specific incentives, and the SMEDP, generate large firm-wide subsidies. METR on inventory capital is high.

- Reform the SMEDP and industry specific incentives so that they only subsidize the marginal investment.
- Move from FIFO to LIFO accounting to reduce the METR on inventories.

**Tourism (METR 13.9%)**
Few sector-wide incentives. Number and complexity of taxes creates problems, especially for small firms. SMEDP administration is weak and creates a very large distortion of the METR. The interpretation of VAT varies widely, especially on transportation.

- Further reduce the number of tax/levy instruments (e.g. Skills Development Levy, UIF).
- Short-term, consider out-sourcing the management of the SMEDP. Longer term, replace with a less generous taxed based benefit.
- Hold a series of workshops with the tourism industry to tackle the application of VAT.

**Financial Sector (29.8%)**
Sophistication of the sector poses challenges for firms and SARS. VAT exemption generates a high METR. Issues over the taxation of insurance funds, retirement accounts and private equity funds. Uncertain tax treatment of deferred income or capital gains from derivatives.

- Consider tax exemption of retirement and insurance company investment fund income.
- Codify and publish the treatment of investment proceeds as capital gains or as ordinary income, as interest or as dividends.
- Codify and publish the tax treatment of private equity (an important source of finance).
- Codify and publish definitions of derivatives and their tax treatment.

**Mining Sector (METR 0.4%)**
Sector receives generous tax treatment. Specific formula for corporate income tax in the gold sector. Proposed 15% diamond export levy intends to promote the local diamond cutting/polishing industry. Pending implementation of royalties creates several issues.

- Remove the gold formula.
- Remove the Diamond Export Levy.
- Resolve existing royalty agreements and alleviate initial royalty burden by exempting initial mine revenues (over +/- 3 years).
EXECUTIVE SUMMARY

This study takes as its point of departure that tax regimes are one of the pillars of the investment climate and thus it has a strong impact on economic growth. Unlike most investigations into the tax regime, which focus on revenue generating mechanisms, this 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 analyzes the tax regime from this lens by sector in order to assess the distribution of the tax burden. In addition, the investigation treats the small business tax regime as a “sector” to determine whether this separate system indeed facilitates entry and compliance of small businesses relative to the standard tax regime. Finally, a comparison between the tax system in South Africa and two sets of comparator countries: a group of countries at similar levels of economic development and a group of neighboring countries in Africa.

The study makes use of two complementary tools of analysis: a quantitative measure of the effective tax burden (marginal effective tax rate—METR – Box 1) which allows for a calibrated comparison between sectors within South Africa and across comparator countries and qualitative analysis carried out by sector specialists to assess the effect of the tax system in practice at the firm level. 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 administrator of the tax system.

The Government of South Africa (GSA) has an ambitious private sector development agenda. Policy is determined primarily with the ‘economic cluster of Ministries, including National Treasury, Department of Trade and Industry and the Department of Public Enterprises. A key aspect of these policies has been to try to identify the critical sectors that act as sources of growth. As part of this ongoing policy development, the GSA asked FIAS to study the effective tax burden on selected sectors\(^2\) as an input into the evolving set of policies in support of the government’s Private sector development goals.

Background

Growth

Real GDP growth in South Africa has averaged 2.5% since 1994. Real GDP growth in 2003 was 3.0%, in 2004 4.5% and is expected to reach 4.9% in 2005.\(^3\)

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\(^2\) The sectors identified are agriculture, tourism, manufacturing, mining, and financial services.

\(^3\) Data provided by the SA Treasury.
While recent growth rates have improved therefore, even higher economic growth however, is necessary in order to reduce the level of unemployment and to have a significant impact on poverty in the country.

South Africa has had a good record on macroeconomic management since 1994. The very high budget deficits of the 1980s have been brought down and inflation has (for the most part) met the 3-6% target set by government. This has been against a background of exogenous events including the Asian financial crises, the events of 9/11/2001 and the situation in Zimbabwe.

Yet levels of savings and investment remain low, at 16% of GDP. Further private sector investment is a necessary condition for higher economic growth in South Africa. This provides the background and context for a study of the tax policy and administration regime. Tax policy and how that policy affects firms decision to invest and grow, forms a fundamental part of any growth analysis.

**Box 1. The Marginal Effective Tax Rate (METR)**

The METR measures the extent to which the tax system reduces the real rate of return on investment, at the margin. More formally, the METR is defined as:-

\[
\text{METR} = \frac{\text{ROR} - \text{ROR}}{\text{ROR}}
\]

where RORbT and RORaT are the real rates of return before and after tax, and ROR is:

\[
\text{Present discounted value of annual net earnings} = \frac{\text{PDV(E)}}{\text{Capital Expenditure}} \times K
\]

For example, let us assume that the rate of return on an incremental capital project is 20% before tax and 10% after, from the equation: METR = (20-10)/20 = 0.5 or 50%. The METR of 50% indicates that the tax system diminishes the real rate of return by 50%. The METR shows how much the tax system distorts investment incentives by driving a ‘wedge’ between the underlying profitability of a project and the after-tax return to the investor. The METR can be compared across projects, sectors, and countries. The larger the METR, the bigger the tax wedge. Differences in the METR reveal tax-induced biases in the incentives that drive the allocation of productive resources. In some cases, the biases are deliberate aims of policy, such as preferences for exporters or for manufacturers in certain locations. In many cases, however, the biases are unintended consequences of the tax system.

It is possible to have a METR which is zero and yet also revenue-positive, as long as the rates of return before and after tax are the same. This can be the case with, for example, 100% deductibility of investment in the first year.

The tax wedge appears at two levels—one arising from taxes on the company, and the second stemming from taxes on the remittance of earnings or capital gains to the owners. There are thus two METRS. The first is in terms of the returns seen by the company undertaking the investment. The second analyses the rate of return to the equity holders themselves rather than the company. The present paper uses the second approach.
Tax revenue

From a macroeconomic perspective, tax policy and administration in South Africa has been very effective at raising revenue. Government has met the 25% revenue/GDP ratio guideline, outlined in GEAR, with ease. In fact, robust revenue growth by the South Africa Revenue Service (SARS) has allowed both increased spending and tax rate reductions in recent years.

Total central government revenues in 2004/5 amounted to R347.9 billion almost all of which came from taxation. Taxation sources are evenly spread. Personal income tax raised 31% of revenues, corporate income tax 20% and VAT (including import VAT) 28%.

Main findings of the report

The main findings of the quantitative and qualitative analysis of the tax/incentive schemes suggest that:

General Conclusions

- 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; thus, the tax system issues identified, though important, are in general second-order problems. The main barriers to growth in these five sectors can be attributed to other administrative and procedural impediments identified, such as rand volatility, skills gaps, distortions around input prices and sector specific issues (see below). However, there are issues, within specific sectors but also economy-wide, which merit review and perhaps policy reform (see below).

- Compared to other countries in the region, South Africa’s METRs on capital arising from the tax and incentive system are higher than Tanzania and Uganda, but lower than Kenya and Zambia.

- Compared to ‘competitor peer countries’ in the OECD (Canada, Australia and New Zealand) the METR on capital in South Africa is relatively low. The aggregate METR on capital is also lower than in India, an emerging economy that has exhibited high growth rates over the past several years.

- On a sector-by sector level, there are variations in effective tax burdens, suggesting that there is room for improvement, but none of these sectors carries an excessive tax burden; the financial sector appears to carry the heaviest effective tax burden and mining the lowest.
The effective tax burden on small businesses can be relatively high, especially if they are not registered for VAT (either through choice or because they are too small to register), and thus cannot reclaim VAT paid on inputs. At the same time, these firms operating outside the tax net face disadvantages not associated with tax liabilities, including the loss of “legitimacy” as a firm, which has implications for obtaining finance and business (especially obtaining government contracts). Thus, although compliance costs incurred by being included in the tax net might be high for many small businesses, it may be worth it in the long-run for some. Currently, very small firms do not have the option to opt into the VAT net.

Two flagship incentive schemes, the Small and Medium Enterprise Development Program and the Strategic Investment Program\(^4\), result in very large negative METRs – indicating a subsidy across the firm as a whole. This should be addressed.

**General Recommendations**

- Significant changes in the tax code are not warranted at the current time. They would create uncertainty within the private sector and act to shift attention away from resolving other issues hampering growth and investment.

- South Africa employs the straight-line approach to tax depreciation, sometimes offering “accelerated” deductions for some sectors. However, because South Africa, like most tax regimes, does not allow inflation indexing, these deductions may not be as “accelerated” as one might think. Moreover, for reasons discussed in the report, a declining-balance approach would be preferred on both administrative and compliance grounds. The latter is particularly important for small business corporations, as there would be no need to keep track of each individual piece of capital.

- Consider moving from FIFO to LIFO accounting. South Africa’s use of FIFO inventory accounting for tax purposes results in very high METRs on inventory capital because of the taxation of inflationary gains. The move to LIFO accounting would do much to lower the overall METR on capital in South Africa, especially benefiting manufacturing firms.

- While the CIT rate of 29% is in line with other countries in the region, and indeed is on the low end. A related issue however, is the Secondary Tax on Companies (STC) which raises the effective corporate tax rate to 36.9%. It would not be advisable to remove the STC without replacing it with something else, perhaps a tax on dividends imposed at the personal

\(^4\) The SIP is now closed for new investments but existing projects are still being monitored.
level coupled with a withholding tax on dividend payments made to non-resident shareholders.

**Political Economy**

The creation of revenue authorities (RAs) separate from Ministries of Finance was initially to maximize revenue generation. There has been little focus on the possible business and growth impact of revenue targets and internal performance incentives. It is clear that the SARS has fulfilled this mandate, as evidenced by continually increasing revenue generation and consistent meeting of the revenue-to-GDP ratios.

The tax authority is the first point of official contact for many small businesses especially in South Africa. Currently, SARS authorities passively discourage small business participation because the system is disproportionately costly to them, in terms of both time and money – the focus instead is on large taxpayers. Small enterprises have little “voice” in the creation of tax policy, which can partially explain why the tax burden for very small firms is relatively high and is a contributor to informality.

Institutionalization of public-private dialogue especially for small businesses (with monthly or quarterly meetings) would address this issue by providing these entrepreneurs with a “voice”. In addition, the creation of a small taxpayer unit would also provide a conduit for information flow between small businesses and the government.

**Recommendations**

- SARS should expand its mandate to include education and outreach of small taxpayers.
- National Treasury and SARS should institutionalize the public-private dialogue especially for small businesses (with monthly or quarterly meetings). This would address this issue by providing these entrepreneurs with a “voice”.
- The creation of a small taxpayer unit would also provide a conduit for information flow between small businesses and the government.

**Sector analysis**

**Agriculture**

Large commercial farmers do not place the tax burden as a major concern. Rather, perceived insecurity over land reform, crime, competition from imports and a strengthening rand are the primary concerns. For small, emerging farmers,
While farming is taxed in accordance with general principles, it is afforded generous provisions. These are probably needed if the objective is to keep people on the land – the returns from farming are low and under increasing pressure from higher input prices and lower output prices. The tax code provides for immediate expensing of capital used to improve land and an accelerated depreciation schedule for farming equipment. Certain farm inputs, and some farm outputs, are also zero-rated for VAT. There are some more esoteric tax breaks such as the ability to defer tax payments by investing profits in the Land Bank, and the outdated prices used to value livestock. Farmers also receive a rebate on fuel duty. The net result is that the average effective tax rate for agricultural enterprises is probably in the range of 0-10%.

Large commercial farmers are in the best position to ‘tax plan’ and take advantage of the various tax benefits. There is probably scope to look at these benefits, especially the more arcane, to simplify the tax code. The recent introduction of ring fencing is a good example of such a reform – though this legislation may well have closed off a useful stream of finance to the agricultural sector, which a hesitant formal banking sector has not replaced.

At the same time, the farming sector faces two areas of tax uncertainty that influence investment decisions. First, implementation of the 2004 Municipal Rates Property Act, could add substantially to the tax burden faced by farmers. The level and administration of this tax will vary by municipality, creating uncertainty within the agricultural sector that could lead to lower investment. Second, though not strictly a tax issue, the future user charges for water administered by Department of Water and Forestry is especially concerning for small emerging farmers who rely on irrigation. Rural users will face increasing competition from urban users, both commercial and residential, which will continue to push up the price for water.

The overall METR on capital for Agriculture is 6%, which is the second lowest of the METR for the sectors studied. Agricultural equipment is eligible for an accelerated 50:30:20 depreciation schedule. This lowers the METR on equipment to 8%; without the accelerated write-off, assuming a standard 5 year write-off, the METR on agricultural equipment rises to 24% and the weighted average overall METR to 10% (equipment has a relatively low capital share weight in agriculture). The METR model assumes that Agricultural enterprises are sole proprietorships and therefore able to use cash accounting for VAT. This lowers
the METR on inventories to 23%. Inventories form an important part of the capital stock in the agricultural sector, and without the cash treatment of inventories the METR on inventories is 40% and the weighted-average overall METR on agricultural capital would be nine percentage points higher at 32%.

**Recommendations**

- With regard to agricultural land, regulate the Municipal Rates Property Act in such a way as to generate certainty on the effective rate, provide appropriate exemption or relief to low income farmers, and avoid placing a tax burden on any improvements and additions to the rural stock of capital.
- The “standard values scheme” for livestock farmers is probably of most benefit to large commercial farmer who are able to use it as a tax-planning tool. Repealing this would simplify the law and bring the treatment of livestock into line with other farm produce.

**Mining Sector**

Almost every country that has a significant mining sector has devised special tax regimes for mining companies. Though these regimes tend to base themselves on normal corporate tax regimes, they have special features, which may include different tax rates or different ways of recognizing income, and which tend to reflect the special status of mining in the history and economy of many countries. (e.g. the disproportionately large share of national wealth that the mining sector may represent; 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; and the employment that mining generates). All of these factors come into play in South Africa.

Main tax issues in the mining sector are as follows:

A specific formula for corporate income tax in the gold sector is meant to encourage development of marginal gold reserves. South Africa’s gold industry is in decline and there is a question as to the utility and justice of maintaining the formula to protect a declining sector.

Royalties will add to mining production costs. There are issues with payment of royalties to existing owners of mineral rights. There are on going debates over whether royalties should be based on revenues or profits, and on whether different minerals should be subject to different royalties. There is a question as to whether 2% royalty on coal will increase cost of electricity and reduce competitiveness of other sectors.
At just above 0%, Mining faces the lowest overall weighted average METR on capital of the sectors studied. There are two reasons for this. First, gold mines are eligible for a formula driven preferential CIT rate that depends upon the ratio of their taxable income to turnover. This substantially lowers the CIT rate in the gold sector. Moreover, depending upon their election of the formula, in some cases gold mines do not have to pay the STC on dividend distributions. The METR calculations for this sector reflect a weighted average of gold and other mining companies, where it assumed that the ratio of taxable income to turnover to gold mining companies is 12% and that gold companies account for 40% of mine investment.

Secondly, 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 included 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.

Like most countries internationally, in SA capital expenditures in mining are ring fenced. This means that the allowances can only be claimed against income generated from the mine to which they are associated. Typically, this means that new mines do not generate taxable income for several years, as the unclaimed capital allowances can be carried forward indefinitely. The calculations ignore this, and assume that capital allowances can be claimed immediately. Incorporating loss carry-forwards and ring fencing is very difficult to do in METR analysis. Depending upon the income profile from the mine, the METR may go either up or down relative to the fully taxpaying scenario. However, it is typically found that METRs calculated ignoring ring fencing is a good approximation of the marginal tax burden.

**Recommendations**

- Re-assess the continued relevance of the gold formula.
- Reduce ring-fencing to allow mining companies to utilize all mining projects in their portfolio.
- Proposed mining royalties
  - Resolve Existing Royalty Agreements
  - Review Proposed Coal Royalties
  - Alleviate Initial Royalty Burden by exempting initial mine revenues (over +/- 3 years) from royalties)
Manufacturing

Manufacturing includes both declining industries (e.g. textiles) as well as growth sectors such as agro-processing. The motor industry is especially successful but dependent upon a generous incentive scheme. Manufacturing relies heavily on both imported capital and imported inputs. Both of these attract nominal tariff rates ranging from 5%-15%. On top of this manufacturing enterprises pay corporate income tax, VAT, capital gains tax and if applicable the secondary tax on companies. Companies uniformly complain about the number of taxes and user charges, each small, but adding up to a substantial tax burden (Skills Development Levy, Unemployment Insurance, Regional Services Levy\(^5\), Property Rates, etc). Outside of the sectors supported by incentives, the average effective tax rate is probably in the range of 30-40%.

The manufacturing sector faces an overall weighted average METR on capital of 21%. Manufacturing firms are able to write-off equipment over four years, at 40:20:20:20, rather than five years at 20% per annum. It is not very likely that this accelerated depreciation schedule drives neither any investment decision, nor the 5% per annum depreciation allowance for industrial buildings. The METR analysis shows this (without this accelerated allowance, the METR on equipment in manufacturing would 25% not 21%, and the overall weighted average METR on manufacturing capital would rise two percentage points to 32%). As indicated above, the METR on inventory capital is high at 40% because of the use of FIFO accounting. Small manufacturing firms face a particular problem with the accrual basis of taxation because they carry significant inventories.

Both very large and very small manufacturing firms benefit from incentives (the Strategic Investment Program\(^6\) (SIP) and the SMEDP respectively), both of which provide very significant subsidies of marginal investments. While the full review of the SIP and SMEDP are pending, it would appear from firm level interviews, and the METR analysis, that both attracted additional capital investment that may well have gone elsewhere, or been delayed. The key question however, is at what cost, given the very substantial subsidy they create for the marginal investment.

**Recommendations**

- In the review of the Strategic Investment Program, and the drafting of any subsequent replacement, carefully assess the METR to ensure that the incentive does not create a subsidy across the firm as a whole. Investment incentives, if any, should aim for a significant reduction in the METR of the marginal investment only.

\(^5\) The Regional Services Levy will be abolished from 30\(^{th}\) June 2006.

\(^6\) The SIP threshold ceiling has now been reached and now new approvals are considered.
• Consider the extension of cash accounting for VAT purposes to incorporated small manufacturing businesses. Further, investigate the extension of cash accounting for the treatment of corporate income tax as well as VAT (while accepting the opportunities for abuse, which this may create).
• Investigate in more detail the cause of the differential between nominal and effective rates of duty on inputs and capital equipment. Consider ways to reduce this differential by, for example, reducing the number of tariff bands and tariff peaks.

Tourism

The amount of direct and indirect taxes does not seem to be a major issue in the sector, the main issue amongst small and large businesses is the complexity of the tax system and the cost and time taken to comply with various taxes. This is especially relevant to payroll taxes, where a number of taxes are paid.

Very few adjustments to the standard, nationally applicable tax policy in South Africa directly benefit the tourism industry. Benefits that do exist include slightly accelerated rates of depreciation on hotel buildings (5% on external buildings and 20% on internal building improvements) and the payment of grants on capital intensive investments under the Small and Medium Enterprise Development Program (SMEDP).7 The corporate tax rate has had limited effect on a large proportion of the tourism sector where profit margins are historically low, due to the highly capital intensive nature of the sector (mainly focused on the purchase of buildings and vehicles). VAT, levied on most products and services used in the sector, provides the largest tax burden in the sector.

Pre-opening expenses can be expensed (Section 11A of the Income Tax Act). However, this rule may not be consistently applied and there is some misunderstanding by the private sector on this issue. There is a strong argument that pre-opening expenses (training, salaries, and marketing, in particular) are revenue generating and should be expensed against future revenue. In order to generate revenue, from the first day of opening of a hotel, for example, considerable pre-opening activities need to be undertaken due to the labor-intensive service nature of the industry and the long relative sales lead times.

The VAT code is complex and its interpretation is a major issue in the sector. There is a lack of clarity on the application of VAT to the various different sub-sectors of the tourism industry, especially on the interpretation of VAT exemption on transport services and the zero rating of export services. Tourists are

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7 Providing a tax free grant over 3 years on investments in buildings, equipment and vehicles equal to 30% of the total investment of up to R100 million.
transported in various forms while visiting South Africa (package tours, day tours, airport transfers, car hire, game drives, etc), and it is unclear which portion of each of these services should be exempt from VAT. There is also a lack of clarity in determining which services in the tourism industry are considered ‘export services’. This is especially evident in the on selling of package tours, which includes a mix of products and services in one country or a multiple of countries, to overseas tour operators and intermediaries. In addition, due to the complexity of the tourism industry where packages can consist of a number of services and products, transfer pricing is required to break up the components of packages and to determine the quantum of VAT to be paid. The subjective nature of transfer pricing and its application in the tourism industry also creates further possible interpretation and application discrepancies.

The SMEDP program has been well received and relatively effective in contributing to growth in the sector by providing capital based incentives to a wide variety of businesses in the tourism industry (hotels, lodges, Bed and Breakfasts, transport operators, etc). Its impact has however been diminished due to the complexity of the compliance process and due to delays in payments, thus defeating the objective of the incentive which is to provide much needed cash flow relief during the initial growth periods of a business.

The overall weighted average METR on capital in Tourism is 14%. This reflects the fact that as a rule Tourism is not eligible for special tax treatment in terms of lower statutory tax rates or accelerated capital expenditure allowances. We have also undertaken an alternative set of calculations for the sector, which includes the impact of the SMEDP – which we found to be particularly important in this sector. This grant ranges from 1% to 10% per annum, depending upon the size of the capital expenditure. Because the SMEDP grant lowers the marginal cost of a unit of capital, it can be captured in the METR calculation, which shows a substantial reduction in the effective tax burden. For example, the METR on equipment is -276%, which implies an extreme subsidy at the margin.

**Recommendations**

- Hold a series of workshops with key industry players and associations to tackle the complexities, interpretation and application of VAT in the tourism sector, especially as it relates to transportation, tour packages and tour operators commission. The intention of this legislation needs clarification and the definitions expanded and improved upon in order to reduce manipulation and limit doubt.
- Consider education sessions and workshops with small to medium sized entrepreneurial operators and representative associations, especially small bed and breakfasts and tour operators, in order to promote the benefits of the small business taxation regime and to encourage formalization.
Consider replacing the SMEDP with an incentive system that reduces the effective tax rate on the marginal project only.

Consider replacing the grant based SMEDP with accelerated depreciation rates of buildings/equipment or introducing an initial investment allowance associated with the development of small and large hotels.

Specifically exclude the transportation of tourists from the VAT exemption granted to public transportation.

Investigate options for formalizing the voluntary tourism levy and using any additional funds generated to boost the international marketing effort of South Africa as a tourist destination.

**Financial Sector**

South Africa has a highly developed financial system, comparable in sophistication and size relative to GDP to those in Europe and North America. Financial sector regulation is also of a first world standard as is, to a high degree, the tax system as it applies to the financial sector. Indeed, the sophistication of the financial sector is one of the main challenges that both financial institutions and SARS face in trying to ensure that taxation of financial services remains equitable and it does not reduce the international competitiveness of South Africa as a financial services centre.

One of the main challenges facing the financial sector, and SARS is attracting and retaining staff with the capacity to understand the tax implications of sophisticated and complex financial instruments, which in turn can reduce the pace of innovation.

The main tax issues in the financial sector are as follows.

Most bank income (i.e., interest) is VAT-exempt. Recovery is according to a formula set by SARS, with an average of only 10% recoverable. Merchant banks and fund managers are subject to same formula, which they claim is not appropriate to their business.

Income in insurance policy funds and retirement accounts is subject to tax and is again taxed on distribution. Double taxation reduces total investment return. Capital gains in insurance policies are taxed at an imputed “average” personal income tax rate, which favors wealthier taxpayers at the expense of poorer ones.

Proceeds from investment by fund managers in Private equity/VC funds are treated as ordinary income, not capital gains.
Uncertainty with regard to tax treatment of deferred income or capital gains from derivative instruments.

With an overall weighted average METR on capital of just under 30%, the financial sector bears one of the highest marginal tax burdens on capital of any of the sectors studied. This is the case for two reasons. The first is because the sector is not the beneficiary of any special incentives in terms of the statutory CIT rate or allowances for its capital expenditures. The second has to do with VAT. With some exceptions, most of the activities of banking institutions, an important part of the financial sector, are exempt from VAT. This means that banks do not charge VAT nor are they able to claim input credits for the VAT paid on much of their inputs. Thus, like non-registered SBCs, banks can bear a heavy effective ‘sales tax’ type burden on their inputs. Information from SARS suggests that about 25% of the turnover of all financial institutions is tax exempt. The resulting indirect tax on bank inputs is what generates the high METR on capital equipment in the financial sector.

It should be noted, however, that while the METR calculations suggest a high capital tax burden on the financial sector, there are many subtleties of the tax system as it relates to this sector that cannot be captured by the METR methodology. In particular, structured financing and the ability of financial institutions to easily move money, and book loans, between jurisdictions is a well known problem in this sector.

**Recommendations**

- Develop and set out clearer definitions and eligibility criteria for treatment of investment proceeds as capital gains or as ordinary income, as interest or as dividends.
- Exempt interest, dividend, rental and capital gain income in retirement funds and insurance company investment funds from taxes.
- Tax treatment of Private equity:
  - Allow funds to operate as tax exempt pass-through entities
  - Treat all Private equity fund income as capital gains. Even if funds themselves are structured as tax-exempt pass-through structures, the eventual tax treatment of distributions from Private equity funds is important in jurisdictions in which capital gains are subjected to lower tax rates than ordinary income.
  - Allow profits from investments by general partners in a fund to be treated as capital gains;
  - Treat carried interest earned by fund managers as capital gains instead of ordinary income.
  - Subject fund management fees paid by offshore and domestic investors to equal treatment.
Establish clear definitions of derivatives and clearer rules on how they are taxed.

**Small Business Sector**

The small business ‘sector’ in South Africa can be broken down into two groups. The first comprises those firms registered with the relevant authorities and who benefit from the specific tax regime designed to assist them. The second consist of smaller, often (but not always) informal firms, who may or may not be in the tax net.

The first group benefits from the tax regime as it stands and faces a low METR. The second group faces a significantly higher METR.

The Small Business Corporations (SBCs) corporate income tax provisions in SA are restricted to corporate entities with annual gross income not exceeding R6 million. Theses firms benefit from a graduated tax rate, with 0% applied up to taxable income of R35, 000, 10% on taxable income in excess of R35, 000 and up to R250, 000, and the full 29% rate on taxable income in excess of R250, 000. Note that SBCs must pay the STC on dividend distributions, regardless of their taxable income. Registered, tax-paying small manufacturing businesses are able to write-off machinery and equipment immediately, at 100%, rather than the typical write-off rate of 20% per annum (5 years straight line). Other, non-manufacturing, SBCs can write equipment off at a 50:30:20 percent rate over three years.

SBCs with turnover less than R20, 000 cannot register for the VAT, while registration is optional for corporations with turnover in excess of R20, 000 but less than R300, 000, and compulsory for companies with turnover in excess of R300,000. Firms below the minimum threshold, or who do not voluntarily register for VAT, define the second group of very small enterprises.

The registration thresholds are designed to lower VAT compliance costs for small business owners. There is no doubt that the thresholds accomplish this objective, as small business owners often find VAT compliance complicated and costly. A difficulty that arises from this, however, is that very small enterprises, not registered for VAT (because they are too small or informal) end up paying VAT on their business inputs, and in particular on their capital. With a VAT rate of 14%, as will be seen below, this can have a significant impact on the METR on capital.

The report illustrates that there is a wide variation in METRs on capital between firms in the small business sector, depending upon the VAT status of the firms and their CIT rate. The METR analysis suggests that the special provisions for
SBCs implemented in South Africa do lower the METR on capital for some firms in this sector, and therefore encourage investment relative to large corporations. However, not all small firms share these benefits for two reasons.

First, SBC registration in the VAT is not high. Indeed, SBCs with turnover of less than R20,000 cannot register for the VAT. This means that purchases of inputs by these corporations bear the VAT, and the SBC cannot claim the input tax credit. Even businesses that pay no corporate income tax face very high effective tax rates on capital because of the VAT imposed on equipment. Indeed, non-VAT registered SBCs face among the highest METRs of any sector. This highlights the importance of bringing SBCs into the tax net.

Second, SBCs differ from large corporations in that they are unable to access international financial markets. These businesses effectively face a segmented local capital market that one can think of as closed for analytical purposes. This means that personal income taxes paid by South African investors in SBCs may well have a sizable effect on domestic investment by lowering the after-all-taxes (corporate and personal) rate of return. This suggests that if one considers the impact of the entire tax system – corporate and personal taxes – on small businesses in a closed capital market context, the METR on “entrepreneurial” investment undertaken by small businesses, is quite high. Contrasting the METRs in Table A and Table B shows this.

Table A. Marginal Effective Tax Rates on Capital: South Africa, Large Corporations, Small Open Economy Assumption, Current Regime

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>14.0%</td>
<td>8.0%</td>
<td>-31.8%</td>
<td>43.3%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Buildings</td>
<td>25.6%</td>
<td>5.0%</td>
<td>22.5%</td>
<td>17.1%</td>
<td>13.5%</td>
</tr>
<tr>
<td>Land</td>
<td>5.3%</td>
<td>5.3%</td>
<td>5.0%</td>
<td>5.3%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>32.4%</td>
<td>5.3%</td>
<td>31.2%</td>
<td>32.4%</td>
<td>32.4%</td>
</tr>
<tr>
<td>Total</td>
<td>21.3%</td>
<td>5.7%</td>
<td>0.4%</td>
<td>29.8%</td>
<td>13.9%</td>
</tr>
</tbody>
</table>

Table B. Marginal Effective Tax Rates on Capital: South Africa, Small Corporations, Small Closed Economy Assumption, Current Regime, Not VAT registered

<table>
<thead>
<tr>
<th></th>
<th>0% CIT</th>
<th>10% CIT</th>
<th>29% CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>61.7%</td>
<td>62.4%</td>
<td>65.9%</td>
</tr>
<tr>
<td>Buildings</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Land</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Total</td>
<td>51.0%</td>
<td>40.0%</td>
<td>41.7%</td>
</tr>
</tbody>
</table>
Recommendations

- Government should make every effort to bring SBCs into the tax net. For SBCs “in the tax net” – paying corporate income taxes and VAT registered – METRs on capital are relatively low. This is the policy intent of some of the measures in the income tax geared towards SBCs. However, for SBCs “outside of the tax net” METRs can be quite high, particularly due to non-VAT registration.

- One important part of this process is to undertake a sustained effort of outreach, training and education to bring small firms into the tax net.

- Review Incentive Programs: The METR analysis shows that, under some circumstances small businesses in South Africa can face very high METRs on capital, particularly if they are not VAT registered. However, the SMEDP program is not a very good way of dealing with this. As discussed in the report, a better approach is to take steps to bring small business corporation into the tax net. Moreover, the SMEDP program can result in large negative METRs on capital.

- In the short term, consider outsourcing the SMEDP management of the program in order to improve response times and help ensure the benefit is provided when intended. Alternatively, replace it with an incentive scheme operated through the tax system, such as accelerated depreciation or investment tax credits.

- Consider implementing a simplified VAT approach for small businesses. One option is to allow all incorporated firms, whatever their size, to register automatically for VAT when they register as a business. SARS could provide a VAT number with the Taxpayer Identification Number (TIN).

Analysis of the Tax System Relative to International Comparisons

METR calculations for selected comparator countries are calculated. Calculations are undertaken for two sectors – the manufacturing sector and the broad service sector, the latter being an amalgam of various non-manufacturing sectors. These suggest that South Africa is relatively competitive within this group of countries. In particular, in terms of the developed OECD economies (such as Canada, Australia, and New Zealand), the METR on capital in South Africa is relatively low. The aggregate METR on capital in South Africa is also lower than India, an emerging economy that has exhibited relatively high growth rates over the past several years.

The story changes somewhat with respect to selected less developed African countries. Here we see that the story is mixed. The South African aggregate METR is higher than Tanzania and Uganda, but is lower than Kenya and Zambia.
The lower METRs in Tanzania and Uganda are due to targeted incentives. The METR calculations in Kenya and Zambia are skewed because of relatively high levels of inflation in these two countries, particularly in Zambia. Inflation interacts with the tax system in complicated ways. For example, the high rate of inflation in Zambia results in a heavy tax subsidy for land, because of the deductibility of nominal interest charges, and a very high tax burden on inventories because of the taxation of inflationary increases in the value of inventories arising from FIFO inventory accounting.

It is typically believed that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of other factors and attract capital. In some ways South Africa shares characteristics of both developed and developing economies, and so its status as a “in between” country in terms of METRs seems sensible. However, one must be cautious in this assessment.
1. INTRODUCTION

In December 2004, FIAS and the United Kingdom Department for International Development (DFID) agreed terms of reference for a joint project, “A Multi-Country Study of the Tax System on Growth in Africa”. This followed the successful piloting of a similar study in Zambia.\(^8\)

South Africa was identified as an important country for analysis as part of this multi-country study. Since 1994, the Government of South Africa has embarked upon several major policy initiatives designed to boost Private sector investment and growth. In August 2005 the Government of South Africa requested that FIAS undertake a study into the METR of key growth sectors as an input to this ongoing reform agenda.

This study takes as its point of departure that tax regimes are one of the pillars of the investment climate and thus it has a strong impact on economic growth. Unlike most investigations into the tax regime, which focus on revenue generating mechanisms, this 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 analyzes the tax regime from this lens by sector in order to assess the distribution of the tax burden. In addition, the investigation treats the small business tax regime as a “sector” to determine whether this separate system indeed facilitates entry and compliance of small businesses relative to the standard tax regime. Finally, a comparison between the tax system in South Africa and two sets of comparator countries: a group of countries at similar levels of economic development and a group of neighboring countries in Africa.

The study makes use of two complementary tools of analysis: a quantitative measure of the effective tax burden (marginal effective tax rate—METR) which allows for a calibrated comparison between sectors within South Africa and across comparator countries and qualitative analysis carried out by sector specialists to assess the effect of the tax system in practice at the firm level. 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 administrator of the tax system.

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\(^8\) The Swedish International Development Agency (SIDA) co-funded the Zambia study.
Context of the Study

In 2004, a report the Small Business Project published a study into the “Cost of Red Tape for Business in South Africa”.9 This comprehensive survey identified ‘company and operating taxes’ as a significant administrative barrier. Further, when asked how to avoid government regulation, two common responses were ‘tax evasion’ and ‘keeping the firm below the VAT threshold’.

The Government of South Africa is fully aware of the difficulties many businesses face when paying tax. During the 2005 Budget Speech, Finance Minister, Trevor Manuel states “...we have directed attention this year at the costs and complexity for small businesses of the tax code, because there is compelling evidence that simplified arrangements can assist significantly in creating an environment conducive to enterprise development.”

With this background, the GSA asked FIAS to investigate the effective tax burden in the key sectors identified as potential growth sectors, as the tax system is one of the pillars of the investment climate. This work fits into the GSA’s strategy of undertaking a targeted review of its policy structure is conducive to Private sector growth. In this context, FIAS worked with the government to determine whether the tax/incentive system, including both the policy and application of policy, was growth enabling.

The remainder of the report is organized as follows. The first section presents brief background information and data underpinning the study, including growth, FDI, and tax revenue data and analysis. The second section offers a brief introduction of how the quantitative investigation is carried out using marginal effective tax rate analysis, followed by sector analysis using both qualitative and quantitative methodology. The third section compares the results in South Africa with countries in the region to give a sense of how competitive South Africa’s tax/incentive regime is vis-à-vis other southern African countries. Additionally, as requested by the authorities, the report compares the tax system with some of South Africa’s ‘peer economies’.

Special focus is paid to the Secondary Tax on Companies (STC), VAT and small businesses, as requested by National Treasury and the South African Revenue Service (SARS). Each section concludes with key recommendations to improve the tax system in each of the sectors. Attached to the main report is a series of annexes, which give more detail into the technical calculation of METRs.

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Background to the study

Growth and performance in the past

South Africa has made important strides in improving the macro-economy since 1994. Budget deficits have fallen to sustainable levels and inflation has largely remained within the 3-6% target range set by government. Tax revenue has consistently met the 25%/GDP ratio guideline. Despite this progress, high and sustained levels of growth have proved elusive. Real GDP growth rates since 1994 have averaged just over 3% and been volatile. Part of the explanation for this is the low levels of investment, both domestic and foreign.

The Growth Employment and Redistribution (GEAR) program envisaged ‘a brisk expansion of Private sector capital formation’. Investment over the GEAR period averaged 16%, less than targeted. However, since 2001 investment has started to edge upwards (Table 1), though much of this is driven by government and public enterprise investment.

Table 1. Investment Performance: 2001 - 2005

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005 (est)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment (inc inventories) as % GDP</td>
<td>15.3</td>
<td>16.1</td>
<td>17.2</td>
<td>17.7</td>
<td>17.7</td>
</tr>
<tr>
<td>- of which public, inc public enterprises</td>
<td>4.0</td>
<td>4.1</td>
<td>4.9</td>
<td>5.4</td>
<td>6.1</td>
</tr>
<tr>
<td>- of which private investment</td>
<td>11.1</td>
<td>11.0</td>
<td>11.1</td>
<td>11.6</td>
<td>11.5</td>
</tr>
<tr>
<td>Additional FDI (US$m.)</td>
<td>7270</td>
<td>735</td>
<td>770</td>
<td>475</td>
<td>-</td>
</tr>
</tbody>
</table>

Source: IMF Article IV: South Africa; September 200

Sector contributions to growth

Tables 2 and 3 show the contribution to growth of the various sectors to the South African economy. The sector shares of output have remained relatively stable over the last six years. Agriculture is declining slowly and ‘commerce’ (which includes the majority of economic activity attributed to tourism) is growing steadily. The reduction in the contribution of ‘other’ reflects the relative decline of government spending as deficits have steadily reduced, and the Private sector grown in its place.
Table 2. South Africa: Sector contributions to total GDP, 1998-2003
(percent of total GDP)

<table>
<thead>
<tr>
<th>Sector</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>3.0</td>
<td>3.0</td>
<td>2.8</td>
<td>2.9</td>
<td>2.6</td>
<td>2.6</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>7.2</td>
<td>6.9</td>
<td>6.7</td>
<td>6.5</td>
<td>6.6</td>
<td>6.6</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>16.6</td>
<td>17.3</td>
<td>17.3</td>
<td>17.2</td>
<td>16.6</td>
<td>16.4</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>2.5</td>
<td>2.5</td>
<td>2.3</td>
<td>2.2</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Construction</td>
<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
<td>2.4</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Commerce (inc. retail, hotels, restaurants)</td>
<td>12.8</td>
<td>13.3</td>
<td>13.2</td>
<td>13.0</td>
<td>13.5</td>
<td>13.9</td>
</tr>
<tr>
<td>Transportation and communication</td>
<td>8.4</td>
<td>8.8</td>
<td>9.0</td>
<td>9.5</td>
<td>9.7</td>
<td>9.9</td>
</tr>
<tr>
<td>Financial and other services</td>
<td>17.1</td>
<td>16.9</td>
<td>17.8</td>
<td>18.3</td>
<td>18.5</td>
<td>18.6</td>
</tr>
<tr>
<td>Other*</td>
<td>30.1</td>
<td>29.1</td>
<td>28.5</td>
<td>27.9</td>
<td>27.7</td>
<td>27.4</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: South African Reserve Bank and Statistics South Africa
* Includes Government and Personal services, subsidies.

Sector growth rates have been mixed and often erratic. Agriculture’s output has been the most volatile, with a standard deviation of 5.2%, due to variability of weather and the value of the Rand. Tourism also suffered in the wake of September 11, 2001. Transportation, communication and financial services have shown strong growth with less overall volatility than other sectors.

Table 3. South Africa: Real Sector Growth, 1998-2003

<table>
<thead>
<tr>
<th>Sector</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>6.2</td>
<td>4.7</td>
<td>-3.3</td>
<td>6.5</td>
<td>-6.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>-1.4</td>
<td>-1.1</td>
<td>-0.1</td>
<td>1.0</td>
<td>4.3</td>
<td>4.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>0.6</td>
<td>8.1</td>
<td>3.2</td>
<td>2.8</td>
<td>-0.9</td>
<td>2.6</td>
</tr>
<tr>
<td>Electricity, gas and water</td>
<td>-0.5</td>
<td>3.1</td>
<td>-3.7</td>
<td>0.2</td>
<td>0.4</td>
<td>1.9</td>
</tr>
<tr>
<td>Construction</td>
<td>-1.4</td>
<td>5.6</td>
<td>4.9</td>
<td>5.8</td>
<td>5.2</td>
<td>6.3</td>
</tr>
<tr>
<td>Commerce (inc. retail, hotels, restaurants)</td>
<td>7.6</td>
<td>8.1</td>
<td>1.9</td>
<td>2.3</td>
<td>6.7</td>
<td>6.5</td>
</tr>
<tr>
<td>Transportation and communication</td>
<td>5.2</td>
<td>8.3</td>
<td>5.9</td>
<td>9.0</td>
<td>5.2</td>
<td>5.5</td>
</tr>
<tr>
<td>Financial and other services</td>
<td>5.1</td>
<td>3.2</td>
<td>8.2</td>
<td>6.2</td>
<td>4.1</td>
<td>3.8</td>
</tr>
<tr>
<td>Total</td>
<td>2.4</td>
<td>4.2</td>
<td>2.7</td>
<td>3.6</td>
<td>2.8</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Source: South African Reserve Bank, IMF
* Includes Government and Personal services, subsidies.

This report will concentrate on the internal factors, tax and incentives issues in an attempt to understand better whether tax policy and implementation is growth promoting or growth inhibiting in each of the selected sectors and to assess South Africa’s competitiveness in each of these sectors vis-à-vis its competitor countries, both regionally and internationally.
Foreign direct investment in South Africa and the business climate

Brief Overview of the Current Investment Climate in South Africa

Macro and micro economic policies in South Africa have had a mixed impact on the investment climate. Table 4 illustrates how South Africa compares with its peers, using data from the ‘World Development Report 2005: A Better Investment Climate for Everyone’. On overall investment risk, South Africa performs well in comparison with the rest of the world, other middle-income countries and sub-Saharan Africa. A similar picture emerges with regard to the intensity of local competition; South Africa has fewer entrenched monopolies than its peers do. The South African government also scores well in terms of policy transparency. Only in the category, regional disparities, does not score well.

Table 4. South Africa’s investment climate performance in comparison

<table>
<thead>
<tr>
<th>Metric</th>
<th>Metric</th>
<th>South Africa</th>
<th>World Average</th>
<th>Middle Income Average</th>
<th>Sub-Saharan Africa Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment risk profile 1-12</td>
<td>1= highest</td>
<td>10.5</td>
<td>8.8</td>
<td>8.7</td>
<td>7.2</td>
</tr>
<tr>
<td>Intensity of local competition 1-7</td>
<td>1= lowest</td>
<td>5.3</td>
<td>4.7</td>
<td>4.6</td>
<td>4.2</td>
</tr>
<tr>
<td>Regional disparities in investment climate 1-7</td>
<td>1= none</td>
<td>2.9</td>
<td>3.4</td>
<td>3.1</td>
<td>2.9</td>
</tr>
<tr>
<td>Transparency in policy-making 1-7</td>
<td>1= lowest</td>
<td>4.3</td>
<td>3.9</td>
<td>3.5</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Given this generally favorable report, it is pertinent to ask why South Africa has not performed better in terms of investment and growth. One set of analyses highlights the fact that the microeconomic reforms have not matched the progress made with the macro-economy. Distortions exist within both the input and output markets, and especially within the labor market. The mismatch between macroeconomic and microeconomic policy has created an environment where investment and growth has not been as high it could be.

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10 This argument remains extremely controversial. For a good review of wider debates, see Fedderke (2004) and Lewis (2002).
Foreign Direct Investment into South Africa

Despite an initial positive response to the democratic elections of 1994, since then FDI in South Africa has averaged less than 1% of GDP. By comparison, over the same period, FDI/GDP averaged 2.5-3% for Argentina, Brazil, and Mexico, 4-5% for Hungary and the Czech Republic, and 3-5% for Malaysia, the Philippines and Thailand.

Figure 1: Foreign Direct Investment into South Africa

![Graph showing foreign direct investment into South Africa]

Tax Policy in South Africa

Tax and incentive policies are key parameters in defining a business climate. Taxes are essential for the financing of government activities, but at the same time, they should be set and administered to be as growth enabling as possible. Thus the revenue raising authorities (in the South African case it is the National Treasury that sets tax policy and SARS which administers it) must set a tax policy which meets both needs.

11 For a complete description of the tax system in South Africa refer to the SARS website <www.sars.gov.za>.
Foundations and Background

The principal Acts governing tax policy in South Africa are:

- Income Tax Act, 58 of 1962;
- Customs and Excise Act, 91 of 1964;
- The 1969 Customs Union Agreement;
- VAT Act 89 of 1991, as amended;
- South African Revenue Service Act 34 of 1997;
- Public Finance Management Act 1 of 1999;

South Africa has a residence-based system; residents are - subject to certain exclusions - taxed on their worldwide income, irrespective of where their income was earned. Foreign taxes are credited against South African tax payable on foreign income.

The legal framework for taxation administration is defined by regulations, guidelines, specific schemes, and South Africa’s adoption of international obligations, such as the WTO Valuation Agreement. South Africa has also concluded Double Taxation Treaties with 53 countries to avoid double taxation of companies operating in other countries as well as South Africa.

Description of tax instruments described in this study

This study will concentrate on taxation of the corporate sector, primarily:

- Corporate Income Tax
- Value Added Tax (VAT)

In addition, companies may have to pay the following contributions during their operations, depending on the type of business:

- Capital gains tax
- Customs duty;
- Excise tax;
- Transfer duty and Stamp duty
- Withholding tax (PAYE and the Secondary Tax on Companies);
- Skills Development Levy;
- Regional Services Levy (to be abolished in June 2006);
- Unemployment Insurance Contributions;
- Municipal levies.
The general corporate tax rate is 29% of profits (recently reduced from 30%). Profits are defined as revenues minus costs of goods sold, expenses incurred in the undertaking of the business and depreciation. Points to note about the corporate income tax regime:

- Small businesses (incorporated) benefit from a graduated corporate income tax regime (Table 5).
- There is a secondary tax on companies, imposed on dividends declared and withheld by the company at 12.5%.

<table>
<thead>
<tr>
<th>Table 5. South Africa: Schedule of Corporate Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category</td>
</tr>
<tr>
<td>General</td>
</tr>
<tr>
<td>Small businesses with a taxable Income less than R35,000</td>
</tr>
<tr>
<td>Small businesses with a taxable income between R35,000 and R250,000</td>
</tr>
<tr>
<td>Taxable income over R250,000</td>
</tr>
</tbody>
</table>

Source: South African Revenue Services

The VAT is set at 14% and taxable value is the selling price including excise taxes, if applicable. Certain items either are zero-rated (subject to the VAT at the zero rate with refunds previously paid) or exempt from VAT (no output VAT is payable nut no input VAT previously paid can be claimed). While there are no formal published criteria for the decision whether to assign an item to zero-rating or exemption, it is clear that the products and services which are zero rated or exempt are those consumed disproportionately by poorer households. This is common practice with VAT regimes, which without such exemptions can be regressive.

Producers of zero rated items are able to obtain refunds on VAT already paid on inputs, where-as the VAT paid on inputs used to produce goods exempt from the VAT cannot be refunded. Major zero-rated items are:

- Exports of goods and services from South Africa, including directly linked services; The exporter must produce proof of exportation, e.g. commercial invoices, certified copies of the documents presented to SARS and at the country of destination and proof of payment, if applicable;
- Certain basic foodstuffs (except when sold as a meal or refreshment) including: brown bread, dried mealies, eggs, fresh/frozen fruit and

12 http://www.acts.co.za/vat/index.htm
vegetables, dried beans, lentils, maize meal, rice, vegetable oil excluding olive oil, mealie rice, legumes, milk;
- Illuminating kerosene;
- Fuel levy goods (e.g. petrol and diesel);
- The sale of a business or part of a business as a going concern (if in writing and meeting certain requirements);
- Agricultural inputs;
- Certain services provided to foreign residents and businesses in respect of goods temporarily imported for modification, service or repair;
- Direct and certain indirect exports.

Exempt supplies are supplies of goods or services on which VAT is not chargeable at either the standard or the zero rate and does not form part of taxable turnover. If you make only exempt supplies, you cannot register as a vendor for VAT purposes. Accordingly, VAT incurred on any expenses in order to make exempt supplies may not be claimed as input tax.

Goods and services exempted from VAT in South Africa include;
- Financial services (interest, life insurance, medical schemes, provident, pension and retirement
- Annuity funds;
- Donated goods or services sold by non-profit bodies (e.g. church bazaars);
- Renting a dwelling for use as a Private home (but not holiday accommodation);
- Passenger transport in South Africa by taxi, bus, or train;
- Education services (crèches, primary and secondary schools, universities, technikons and other institutions registered under an educational Act).

Sole proprietors with a turnover of less than R2.5 million may use cash accounting (the ‘payment’ system) for VAT. Otherwise, the invoice payment method (accrual accounting) is required. If the VAT due is not paid to SARS by the due date a penalty of 10% of the outstanding amount of VAT is levied. SARS also charge interest on late payments.

VAT payments are ‘suspended’ for goods imported to a bonded warehouse or to a Industrial Development Zone (IDZ). If goods are subsequently sold within South Africa the VAT is re-applied, if goods are exported (the purpose of IDZs), then no VAT is applied.

Businesses with a taxable turnover exceeding or likely to exceed R300,000 in any 12-month period have the statutory obligation to register with the SARS for VAT monthly payments (VAT). SARS issue a VAT registration number, which vendors must carry on every invoice. No registration fee is applicable. SARS
may waive VAT registration if it is convinced that the business deals only with exempt goods or services. Companies with an annual turnover under R300,000, but over R20,000, may opt to register for VAT. Companies with a turnover below R20,000 may not register for VAT.

**Tax Revenues Performance**

From a macroeconomic perspective, tax policy in South Africa has been effective at raising revenues. The 25% tax/GDP ratio is the highest rate in sub-Saharan Africa and is comparable with other middle income countries. SARS have managed to meet this target ratio with ease and revenue growth has been sufficient to allow reduced tax rates and real increases in expenditure. The nominal average growth rate of revenue has been 13% since 1999/2000.

Total central government revenue in 2004/5 was R347.9 billion (US$53.28 billion). Almost all of this was collected through taxation, with the largest sources being personal income tax at 31% of revenues and VAT (including import VAT) at 28% (see Figure 2).

**Figure 2: South Africa: Central Government Revenues 2004/5**

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South Africa: Central Government Revenues 2004/5

PIT (31%)
CIT (20%)
STC (2%)
VAT (28%)
Customs & Excise Taxes (10%)
Other (Payroll, Retirement Funds, Property, Trade)
```

Source: South Africa Revenue Service
Political Economy

The Role of the Revenue Authority

Background

The creation of revenue authorities (RAs) separate from Ministries of Finance was initially to maximize revenue generation. There has been little focus on the possible business (and therefore growth) impact of revenue targets and internal performance incentives. An additional aim of this study, and the others in Southern and East Africa, is to develop an understanding of the way in which RAs work and then to determine how the role of RAs can be enhanced to promote growth; i.e., the project aims to understand the business impact of African RAs. ‘Doing Business 2006’\(^{13}\) showed that countries that tax highly and have complex regulations (and hence provide strong incentives to evade), generally receive lower tax revenues than countries with low rates and broader tax bases. This finding may reflect both political issues and poorly devised bureaucratic procedures. This project seeks to explore these dimensions of how RAs administer tax policy, taking business as the unit of analysis.

SARS in practice

The role of the revenue authority—in this case SARS, as a separate agency from National Treasury, is to be the administrator of tax policy. Another way of looking at it is the SARS is the interface between the government and the taxpayer. The “traditional” role of the SARS has been to maximize revenue collection—especially from large enterprises. It is clear that the SARS has fulfilled this mandate, as evidenced by continually increasing revenue generation and consistent meeting of the revenue-to-GDP ratio guideline (25%).

At the same time, SARS has taken its role a step further and concentrated on client-service, again concentrating on large enterprises. The idea is that the provision of service and outreach to large enterprises will facilitate tax compliance and thus maximize revenues generated. Firm interviews across sectors have confirmed that this approach is broadly successful and that it has contributed to a strong culture of compliance among large enterprises.

Analysis

The tax authority is the first point of official contact for many small businesses especially in South Africa. In a sense, the revenue authority has the power to

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\(^{13}\) The Doing Business database provides objective measures of business regulations and their enforcement. See <http://www.doingbusiness.org/>
encourage or discourage firms from entering the tax net. Currently, SARS authorities passively discourage small business participation by making the system both time and financially costly. This result is due to the revenue authorities’ mandate, which is to raise revenue to finance the government; as a result, human and financial resources for this purpose are allocated accordingly.

From firm interviews, it became clear that the revenue authorities were both effective and responsive in meeting the needs of large and medium-sized taxpayer, but not effective at meeting the needs (education and training) of existing and prospective small business taxpayers. The lack of outreach to small businesses is not unique to South Africa; however, given the government’s policy goal to facilitate the growth of small businesses, it is that there is yet a system in place that would offer training and education for small businesses. At the same time it should be noted that the authorities are aware of the issue and plan to address it in the next few years.

In addition to offering education on how to comply with the law and basic accounting skills, the revenue authority could also educate firms on what becomes available (access to finance, markets, cooperatives, etc.) once they enter the tax net. These activities would produce short and long run results. In the short run, the number of small firms in the tax net would rise, and build capacity. This would have some impact on short-run economic growth. However, in the long run, many of these firms will grow and become larger taxpayers. The net result would be an increase in revenue for the government and higher economic growth in general. Thus, the enhanced role of the tax authority can be seen as an investment into long-run growth.

Functionally, given the size of the small business sector, both formal and informal, SARS should create a small business unit, analogous to the large taxpayer unit to focus on small business tax compliance issues, especially to the extent that they cause informality. This unit should concentrate on outreach and education on tax issues.
Box 2. Setting up a small taxpayer unit within the revenue authority

The functional activities (i.e. registration, accounting, collection, enforcement and audit) must be simplified to make it cost-effective for tax offices and taxpayers, especially medium SMT-formal entities. Small Business Tax Units should be set up to focus on segments of taxpayers and skills of tax officials as well as improving functional administration. In particular, the tax accounting section should be separated from the audit and enforcement units to make internal control procedures effective. The headquarters must include small business activities in its planning, control and feedback processes to ensure optimum utilization of scarce resources. In addition to coordinating and supervising operations for a cluster of small offices, regional offices can be used as processing centers and also organize special teams to implement more advanced enforcement programs (e.g. special audits and investigations).


Tax Policy Making: The Role of the Private Sector

Although South Africa has an extensive consultative process and public-private dialogue, discussions with both the SARS and the private sector indicate that most of the public-private interaction in the tax arena occurs after tax policy has been adopted by the government. This ex post dialogue serves mainly as information dissemination, rather than as input from the private sector.

At the same time, large enterprises report that they meet occasionally with the SARS on specific issues that affect individual firms. The large taxpayer unit (LTU) facilitates some of this dialogue within SARS. Small and medium-sized enterprises in particular do not have such a formal mechanism. This is often the case as they are geographically and functionally diverse and not organized

Analysis

Lack of institutionalized public-private dialogue in tax policy formation suggests that the government is less responsive to the needs of business than they could be, a situation which may be exacerbating the adversarial relationship between government and the private sector we found in certain sectors. Small enterprises in particular have less of a “voice” in the creation of tax policy. It is acknowledged that small businesses do receive favorable treatment under the tax code as laid out in legislation. However, the wider issue about very small (often informal) firms is not as adequately addressed. Institutionalization of public-private dialogue especially for small businesses (with monthly or quarterly meetings) would address this issue by providing these
entrepreneurs with a “voice”. In addition, the creation of a small taxpayer unit would also provide a conduit for information flow between small businesses and the government.

**Recommendations**

- SARS should expand its mandate to include education and outreach of small taxpayers.
- National Treasury and SARS should institutionalize the public-private dialogue especially for small businesses (with monthly or quarterly meetings). This would address this issue by providing these entrepreneurs with a “voice”.
- The creation of a small taxpayer unit would also provide a conduit for information flow between small businesses and the government.
2. **ANALYSIS OF THE EFFECTIVE TAX BURDEN IN SOUTH AFRICA**

**Assessing the effective tax burden - an introduction**

Assessment of the effective tax burden in South Africa requires a standardized, quantitative metric which takes all provisions of the tax code and incentive scheme in place to look at what a hypothetical new entrepreneur would face if he or she were to invest today in that sector. At the same time, qualitative analysis is also needed to determine how the tax/incentives scheme is applied in practice. This section presents both the qualitative and quantitative analyses of five key sectors in the economy—agriculture, manufacturing, tourism, mining, and finance—to present a comprehensive picture the absolute and relative tax burden.

**Quantitative analysis of the effective tax burden**

The concept of a marginal effective tax rate (METR) was created to analyze in a single measure how investment decisions are affected by the large number of provisions of the business and individual income tax systems, as well as by features of any property and wealth taxes, sales taxes including VAT, customs duties, and special incentive regimes such as tax holidays, that affect the incentives to invest. METR analysis is based on the standard neoclassical model of investment in which the level of investment is a function of the “cost of capital” faced by a firm – the minimum or “hurdle” rate of return that an investment must earn to be profitable. Although earlier research was mixed on the issue, the most recent empirical evidence confirms the basic assumption of this model – investment does in fact react inversely to changes in the cost of capital (Gordon and Hines, 2002). METR analysts, such as King and Fullerton (1984), Broadway, Bruce and Mintz (1984) and many others, have taken the basic neoclassical model and modified it to take into account the net effect of all the provisions of a tax system on the cost of capital to the firm. The primary goal of an METR analysis is thus to describe this net effect of a tax system on investment incentives in a straightforward and intuitively appealing form.

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14 See Annexes I and 2 for a more full description of METR theory and calculations.
15 See K. Hassett and R. Hubbard (2002), Tax Policy and Business Investment, chapter 20 in Volume 3 of the Handbook of Public Economics (Elsevier). The authors conclude “a consensus has emerged that investment demand is sensitive to taxation and neoclassical investment models are useful for policy analysis.”
16 The analysis in this paper most closely follows the approach in Broadway, Bruce and Mintz (1984). For an application of the King and Fullerton (1984) approach to Burundi, see Zodrow (1993).
The METR terminology naturally provides some insight into the nature of this tool. A METR is marginal because it is based on analysis of a prospective incremental investment – one that just breaks even, with its after-tax cost equal to its after-tax returns.\textsuperscript{17} It calculates the effective tax burden in that it captures the net effects of all the provisions of the tax system, rather than focusing on a single characteristic such as the maximum statutory corporate tax rate. And it is a tax rate in that it is defined as the difference between the gross of tax and net of tax returns to an investment – the “tax wedge” between gross and net returns created by the tax system – expressed as a percentage of the gross return.

The calculation of an METR requires careful specification of:

- the investment, the asset;
- the sector;
- the time path of its returns;
- the rate of economic depreciation of the asset;
- how the asset is financed;
- the economic environment in which it occurs, including the inflation rate, interest rates, and returns to equity;
- all features of the tax system affecting both the after-tax returns and the after-tax costs attributable to the investment, (including all tax depreciation allowances, investment credits, interest deductions, special exemptions, etc.), allowed under the income tax as well as any other taxes that impinge on investment decisions.

Given this information, the analysis calculates the effective tax rate on a marginal or breakeven investment under the assumptions of profit maximization by the firm, competitive markets, and perfect certainty (e.g., with respect to future returns and inflation rates).

It is important to emphasize that the METRs calculated for this study measure the effective tax burden on capital, and that taxes that corporations pay on their other inputs, that do not impinge on the rate of return to capital, such as payroll taxes, are not reflected in the METR on capital. It is also important to emphasize that METR analysis is only a tool in the analysis of the tax system. The methodology only captures the “big picture” effects of the tax system. Several simplifying assumptions must be made, and important nuances of the tax code cannot be captured in METR calculations; the calculations should be interpreted in this light.

\textsuperscript{17} METR analysis is thus not well suited to analyzing tax effects on investments that generate above-normal returns.
A high METR on capital is not only indicative of a tax system that discourages investment, but differences in METRs across assets and sectors introduce distortions in the allocation of investment.

**Summary of Marginal Effective Tax Rate Analysis in South Africa**

Tables 8, 9 and 10 illustrate METR calculations in South Africa for different sectors and assets and under varying assumptions regarding the openness of capital markets, VAT registration, etc. The calculations for large corporations (Table 6) assume that the capital market in South Africa is small and open to internationally mobile capital. For these firms personal income taxes on the return to savings (interest, dividends, capital gains) paid by domestic (South African) investors do not affect the METR, and therefore have no impact on the incentive to undertake investment; this follows from the fact that the required after-corporate-tax rate of return on investments in this case is fixed by international financial markets. This is a reasonable assumption for larger firms, and is commonly made in METR studies.

For small and medium sized enterprises (SMEs), on the other hand, the assumption of internationally mobile capital in an open economy is less appropriate, as these businesses do not have access to international financial markets, but must rely on local investors for funds. For these SMEs, the local capital market can be viewed as closed, and personal taxes levied on the return to savings locally can distort investment decisions in these types of firms. For comparison purposes, we present a set of calculations for small businesses under the small open capital market assumption (Table 7), but we also present a set of calculations under the closed local capital market assumption (Table 8). Annex A explains the importance of closed vs. open capital markets for investment, in more detail.

Table 6 illustrates that for large corporations there is significant variation in METRs across assets for any particular sector. This primarily reflects differences in the discrepancy between the rate at which firms are able to write-off capital expenditures for tax purposes (tax depreciation), and the rate of decline in the market value of the capital due to obsolescence, wear and tear, etc. (economic depreciation). Both tax and economic depreciation rates vary across assets and sectors. Also, note that with the exception of the Agricultural sector, investments in inventories tend to bear a high tax burden. This is because of the use of FIFO accounting for inventory purposes, which results in the taxation of inflationary changes in the value of inventories.
There is also quite a bit of variation across sectors. This is due to differences in the tax treatment of different types of capital across sectors, but also due to differences in economic depreciation rates and to different capital weights used to aggregate the METRs. For example, equipment accounts for over 50% of capital investment in the broad manufacturing sector, but only for around 20% in Tourism and Agriculture. Similarly, the economic depreciation rate on buildings in the Agricultural sector is about half that in the Manufacturing sector. This means that if buildings are written-off for tax purposes at the same rate in the two sectors, the treatment is more generous for Agriculture than it is for Manufacturing (shown in more detail below).

Table 6. Marginal Effective Tax Rates on Capital: South Africa, Large Corporations, Small Open Economy Assumption, Current Regime

<table>
<thead>
<tr>
<th></th>
<th>Manufacturing</th>
<th>Agriculture</th>
<th>Mining</th>
<th>Finance</th>
<th>Tourism</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>14.0%</td>
<td>8.0%</td>
<td>-31.8%</td>
<td>43.3%</td>
<td>17.4%</td>
</tr>
<tr>
<td>Buildings</td>
<td>25.6%</td>
<td>5.0%</td>
<td>22.5%</td>
<td>17.1%</td>
<td>13.5%</td>
</tr>
<tr>
<td>Land</td>
<td>5.3%</td>
<td>5.3%</td>
<td>5.0%</td>
<td>5.3%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>32.4%</td>
<td>5.3%</td>
<td>31.2%</td>
<td>32.4%</td>
<td>32.4%</td>
</tr>
<tr>
<td>Total</td>
<td>21.3%</td>
<td>5.7%</td>
<td>0.4%</td>
<td>29.8%</td>
<td>13.9%</td>
</tr>
</tbody>
</table>

Table 7. Marginal Effective Tax Rates on Capital: South Africa, Small Corporations, Small Open Economy Assumption, Current Regime

A. VAT Registered

<table>
<thead>
<tr>
<th></th>
<th>0% CIT</th>
<th>10% CIT</th>
<th>29% CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Buildings</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Land</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Inventories</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

B. Not VAT Registered

<table>
<thead>
<tr>
<th></th>
<th>0% CIT</th>
<th>10% CIT</th>
<th>29% CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>49.5%</td>
<td>50.5%</td>
<td>55.6%</td>
</tr>
<tr>
<td>Buildings</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Land</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Inventories</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total</td>
<td>33.9%</td>
<td>17.1%</td>
<td>19.8%</td>
</tr>
</tbody>
</table>
## Table 8. Marginal Effective Tax Rates on Capital: South Africa, Small Corporations, Small Closed Economy Assumption, Current Regime

### A. VAT Registered

<table>
<thead>
<tr>
<th></th>
<th>0% CIT</th>
<th>10% CIT</th>
<th>29% CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Buildings</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Land</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Total</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
</tbody>
</table>

### B. Not VAT Registered

<table>
<thead>
<tr>
<th></th>
<th>0% CIT</th>
<th>10% CIT</th>
<th>29% CIT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>61.7%</td>
<td>62.4%</td>
<td>65.9%</td>
</tr>
<tr>
<td>Buildings</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Land</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>29.3%</td>
<td>29.3%</td>
<td>29.3%</td>
</tr>
<tr>
<td>Total</td>
<td>51.0%</td>
<td>40.0%</td>
<td>41.7%</td>
</tr>
</tbody>
</table>

### Sector Analysis

#### Agriculture

Agriculture contributes 3.2% to the South African economy while accounting for a greater proportion of employment (12%).\(^{18}\) This reflects the fact that much of South Africa’s agricultural output is not commercial and not calculated as part of national income. As with many other parts of the economy, the agricultural sector exhibits a dual structure. There is a large, commercial and ‘first world’ agricultural sector mostly within the tax net and a large number of smaller farmers mostly operating outside the tax net.

### Summary of tax / incentive system

In common with many other countries, both developed and developing, farming operations benefit from a number of special provisions under the tax code.

#### Corporate Income Tax

The following deductions and accelerated depreciation schemes are available for agricultural operations.

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\(^{18}\) Statistics South Africa.
Box 3. Agriculture Sector’s Tax Advantages

Agricultural enterprises may immediately expense capital used to improve land and may be carried forward.

The cost of farming machinery, plant, implements, utensils or articles used by a farmer in farming operations (including the production of bio-fuels (bio-diesel and bio-ethanol)) is written off according to a 50-30-20 schedule.

Livestock farmers may use “standard values” to determine closing stock, but once adopted, these standard values must then be used consistently from year to year. Essentially, this means that a much reduced value is being placed on livestock and hence a greater deduction is being allowed for income tax purposes.\(^\text{19}\)

If livestock is sold in distressed situations (e.g. drought), the revenue generated is not immediately taxable. Tax is only paid when the stock is replaced.

Agricultural co-operatives receive further tax advantages. Storage buildings may be depreciated at 5% per annum, plant or machinery used for storing / packing farming products may be depreciated at 20% per annum, and the distribution of benefits to members is tax deductible.

Since a farmer’s income can fluctuate considerably from year to year, non-corporate farmers may be taxed on the basis of their annual average taxable income from farming in the current and previous four tax years.

Relief is also given to farmers whose income for any year includes income derived from:
- The disposal of plantation and forest produce.
- The abnormal disposal of sugar cane as a consequence of damage to cane fields by fire.
- The disposal of livestock sold because of drought.
- Excess profits as a result of farming land acquired by the State or certain juristic persons.

Value Added Tax

Agricultural inputs are zero rated for VAT (not including capital equipment).

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\(^{19}\) e.g. Opening stock 100 + purchases 1000 – closing stock 200 (assuming one animal with a standard cost of 100, another is purchased at market value of 1000 and accounted for at the standard value of 100 at year end. The farmer now has 2 animals with a standard value of 100 each). When standard values are elected, the deduction is limited to income derived from farming.
Certain foodstuffs are also zero rated for VAT (including: brown wheaten meal, maize meal, samp, mealie rice, dried mealies, dried beans, rice, lentils, fruit and vegetables, eggs). These products may be the output from farms themselves.

Small businesses (agricultural or otherwise) may not register for VAT if they have an annual turnover below R20,000. With a turnover above this figure firms may choose to register for VAT voluntarily, and above R300,000 annual turnover VAT registration is compulsory. (See Small Business Section for more information).

Farmers who (a) consist solely of agricultural, pastoral or farming activities and (b) have a total turnover from all farming activities not exceeding R1 million per annum, may pay VAT every six months rather than every two. Further, under the VAT Act of 1991 (Section 15) sole proprietor farmers (unincorporated farm enterprises) with a turnover of less than R2.5 million may use cash rather than accrual accounting (tax based on ‘payments’ not ‘invoices’) for calculating VAT payable.

**Box 4. Should Agriculture be exempt from VAT?**

It is a common feature that value added in agriculture is taxed relatively lightly. The sector receives ‘special’ treatment because:

- In many developing countries agriculture is outside the formal sector
- Farmers are remotely located making education and compliance difficult
- Agriculture has seasonal revenues
- Exempting, or zero-rating, agriculture is seen as a way to pursue wider social objectives such as lowering the price of food, and supporting poor communities (predominantly rural).

Many of these features are not unique to agriculture and there is no *a priori* evidence that agriculture deserves special treatment. The reality however, is that special provisions are usually provided. The ‘cleanest’ of these is to zero-rate agricultural inputs, although this creates its own problems in terms of defining what is destined for agricultural use or not. Another option is to exempt inputs from VAT although this can lead to ‘exemption creep’. Once in place such schemes are very hard to undo and there are few examples of any country, developed or developing, which effectively moves toward graduating agriculture to a standard tax system. Complications are compounded when thresholds are introduced in an attempt to capture tax on value added from larger farmers.

Input tax credits

Farmers, foresters and mining companies receive a 40c per liter rebate on diesel under the Diesel Refund Scheme. This provides further support to the sector.

The Tax / Incentive Regime in Practice

Background

The sector faces a large amount of perceived uncertainty and a difficult trading environment. Issues include the land reform process, crime, a strong Rand and water prices. These factors, rather than tax, are the primary drivers of investment in the sector.

Farmers are less likely to operate as corporations than enterprises in other sectors. This has implications for how the sector is taxed and the tax code makes specific exception for farmers who are not incorporated versus those who are.

Income Tax

Large, commercial, farms are in the best position to ‘tax plan’ and take advantage of the various tax benefits outlined above. As a result, farmers are not overly concerned with tax issues. The average effective tax rate is between 0% and 10% of income.

There is probably scope to look at these benefits, especially the more arcane, to simplify the tax code. The recent introduction of ‘ring fencing’ legislation is a good example of such a reform – though this legislation may well have closed off a useful stream of finance to the agricultural sector, which the formal banking sector is hesitant to replace.

Value Added Tax

Farmers (unincorporated) benefit from the VAT derogations outlined above. The first derogation (the option to pay VAT every six months) applies only to small farmers to account for the long time lag between incurring input costs and receiving revenue in this sector. The second derogation, the option to use cash rather than accrual accounting for VAT, benefits farmers for similar reasons.

Analysis of the tax regime

The overall METR on capital for Agriculture is very low at just under 6%. There are three reasons for this.
First, agricultural equipment is eligible for an accelerated 50:30:20 depreciation schedule. This lowers the METR on equipment to 8%; without the accelerated write-off, assuming a standard 5 year straight line depreciation, the METR on agricultural equipment rises to 24% and the weighted average overall METR to almost 10% (equipment has a relatively low capital share weight in agriculture).

Second, the relatively low economic depreciation rate on agricultural buildings relative to their tax depreciation rate. Agricultural buildings are longer lived than, say, manufacturing buildings. As such, the 20-year write-off for agricultural buildings is more generous for the agricultural sector than manufacturing.

Third, unincorporated agricultural firms may make use of the cash accounting provision for inventory purposes for VAT. This lowers the METR on inventories substantially to 5.3%; without cash treatment the METR on agricultural inventory would be about 32%. Inventories form an important part of the capital stock in the agricultural sector, and without the cash treatment of inventories the weighted-average overall METR on agricultural capital would be much higher at 18%.
Box 5. Lessons on Rural Land Taxation from Elsewhere in Africa

While taxing rural land is fraught with difficulties, there some experiences from recent history which offer some insights.

In the case of rural land taxation, decentralization of valuation and enforcement activities promotes efficiency. Recent successes with active and effective local Valuation Offices in Zambia have demonstrated this.

Some form of taxation (Flat-rate or site-value) is useful to encourage active land use, as opposed to speculation. Land owners have greater incentive to maximize the productivity of their land when owning it imposes real costs. Local authorities in Kenya in particular have attributed the rapid development of Nairobi and other cities in the 1970s to improved application of land taxation.

Site-value taxation is preferable to flat-rate taxation, because it is more accurate in terms of determining ability to pay taxes, identifying property owners as beneficiaries of public expenditure on social and economic infrastructure, and is more neutral than income taxes with respect to resource allocation. Arguments have been made that taxing development tends to discourage investment, but in the case of agricultural land, site-value taxation can be made dependent on soil quality (representing productive potential) rather than physical improvements.

Research and data management systems for comprehensive and accurate valuation are critical to the success of such systems. Establishing land value need not be a complicated process; in Zimbabwe a simple equation based on land attribute classifications has proven effective. In Tanzania, reforms aimed at strengthening cadastral records and tax administration since 1991 have resulted in visible improvements in collection efficiency.


Other issues

Implementation of the 2004 Municipal Rates Property Act, depending on the municipality, could add substantially to the tax burden faced by farmers. The level and administration of this tax will vary by municipality, creating uncertainty, which could lead to lower investment. Global experience suggests that rural areas are not well served by the simple extension of tax systems designed for urban municipalities. Ideally, the municipalities should only tax the land (the "site value") and not the investments made in the land. Although not strictly a tax issue, the future user charges for water administered by Department of Water and Forestry are especially concerning for small emerging
farmers that rely on irrigation. Rural users will face increasing competition from urban users, both commercial and residential, which will continue to push up the price for water.

**Recommendations**

- It is unexceptional that South Africa provides many exemptions for the agricultural sector. However, a significant proportion of South African farmers is relatively large profitable enterprises and should be taxed as such. SARS need to investigate ways to target any special treatment they see as necessary, to small emerging farmers.
- Application of the Municipal Rates Property Act to agricultural land should be regulated in such a way as to generate certainty as regards the effective rate, provide appropriate exemption or relief to low income farmers, and avoid placing a tax burden on any improvements and additions to the rural stock of capital.
- The “standard values scheme” for livestock farmers is probably of most benefit to large commercial farmer who are able to use it as a tax-planning tool. It could be usefully repealed, simplifying the law, and bringing treatment of livestock into line with other farm produce.

**Mining**

_The vast majority of countries where mining contributes significantly to the economy have special tax regimes for mining companies_, including different tax rates or different ways of recognizing income. This reflects the special status of mining in the economy such as: the disproportionately large share of national wealth that the mining sector may represent; the high risk and high capital intensity of mining; the complex legal and social provisions concerning ownership of mineral resources; the non-renewable character of mineral resources; and the employment that mining generates. All of these factors come into play in South Africa.

South Africa was built on mining. Though mining now accounts for only 7% of GDP, as recently as 1988 it represented nearly 12%. South Africa is the world’s largest producer of gold, platinum group metals and chromium; the world’s sixth largest coal producer (and second-largest exporter); and the third largest diamond producer, accounting for about 15% of world production by value. The mining sector is the country’s largest employer after the public sector, with over 400,000 workers, 180,000 of them on the gold mines.
Summary of tax / incentive system

Corporate Income Tax

Except for gold and uranium, mining companies are subject to the normal 29% corporate income tax. The formula by which gold and uranium mining companies pay tax is described below.

Unlike other companies, mining companies are allowed to deduct all mining-related capital expenditures in the year in which they occurred. The exemption applies not only to investment in mineral production but also to many other costs incurred in the pre-production period, such as management, administration, development, and interest. Other expenditures, including employee housing, schools and hospitals, do not qualify for the exemption and companies must depreciate these on a 10-year straight-line basis.

Although the tax code allows for unlimited carry-forward of the capital exemption, it could be more than ten years before a new mine enters into full production and it could take another several years before the mine generates enough profit for the full capital exemption to be claimed. In recognition of this, mining companies are allowed to transfer up to 25% of the capital exemption from unprofitable mines to offset income from profitable mines.

Ring-fencing in the mining sector limits the capital exemption to income from the mine at which the applicable capital expenditures were incurred. \(^{20}\) This prevents a mining company from transferring the capital exemption from a loss-making mine (or one that has not yet entered production) to the income of a mature mine, which is producing at full capacity but on which capital expenditures may be relatively low. This ring-fencing exclusion can be breached in certain circumstances, but only up to a maximum of 25% of the taxable income from another mine.

\(^{20}\) SARS define ring-fencing as “an anti–avoidance measure in terms of which the expenditure incurred in conducting a trade is limited to the income of that specific trade.” The purpose of ring-fencing is to limit companies’ ability to apply losses or expenses incurred in one set of unprofitable or marginally profitable business activities taxable income received from other business activities.
 Mineral Specific Taxation

The Gold Formula

Gold and uranium mining companies may elect to pay a higher base rate of corporate income tax in exchange for exemption from the Secondary Tax on Companies. The tax rate applied in the 2005/2006 tax year to companies electing the STC exemption is:

\[ \text{Tax} = 45 - \frac{225}{x} \text{ on all mining income, and } 37\% \text{ on non-mining income, where } x \text{ is the ratio of operating profit to total revenue. This implies a marginal tax rate of } 45\%. \]

For companies not electing the STC exemption, the formula is:

\[ \text{Tax} = 35 - \frac{175}{x} \text{ on all mining income, and } 29\% \text{ on non-mining income. This implies a marginal tax rate of } 35\%. \]

The use of the profit to revenue ratio, x, as the denominator, invokes another part of the gold formula known as the “tax tunnel” effect, which in effect grants a tax exemption to mines whose profit to revenue ratio is less than five per cent.

Taxation of the Diamond Sector

Diamond mining is subject to the normal 29% corporate income tax rate, and benefits from standard mining industry capital exemptions. The Diamond Act of 1986 imposes a 15% export duty on uncut diamonds, intended to encourage the development of a cutting and polishing industry in South Africa.

However, Section 59 of the Act allows the South African Diamond Board to enter into agreements with producers to find the optimum way to guarantee adequate supplies to the local cutting industry. Since 1993, there has been an agreement between De Beers, which accounts for more than 90% of South Africa’s diamond production and exports, and the Diamond Board, allowing De Beers to export its production to London, and then provide the South African sight holders the stones they need. De Beers has argued that this arrangement, because it mixes South African diamonds with diamonds from other countries, allows South African sight holders to obtain a better qualities and classes of diamonds than they would if their purchases were restricted to the production from local mines. Given this arrangement, the 15% export duty on diamonds has almost never been applied.
Value-Added Tax

All exports are zero-rated for VAT. Since the bulk of South Africa’s mineral production is exported, this enables mining companies to claim back VAT paid. The extent of exporting varies within the mining sector. For gold and diamond mining companies virtually 100% of produce is exported. This substantially reduces the METR for the gold and diamond sector.

Proposed Changes to Mining Taxation

Diamonds

South Africa’s Parliament on November 1, 2005 passed two Bills: The Precious Minerals Bill and the Diamond Amendment Bill. Both bills are intended to encourage beneficiation of diamonds and precious metals in South Africa, through the imposition of various regulatory controls, beneficiation tax incentives, and tax penalties for export of un-beneficiated minerals.

The Diamond Amendment Bill has the greatest tax implications, since it will eliminate current exemptions from the 15% export duty on rough diamonds, except at the discretion of the Minister of Minerals and Energy. The new law does not indicate under what circumstances the Minister might use her discretion to grant such an exemption.

The Bill also provides for much more central government control of the diamond industry, replacing the existing South African Diamond Board, which is largely made up of industry representatives and funded by levies, with the state-funded and government-dominated South African Diamond and Precious Metals Regulator. The new law will also create a State Diamond Trader that will buy rough diamonds in quantities and at a value determined by the Minister of Minerals and Energy.

Royalties

The Mineral and Petroleum Royalty Bill is still in draft form and will be released for comments towards the end of 2006. Although the exact nature of the proposed system is still far from finalized, initial drafts propose a royalty on all mining revenues ranging from 1% on quarry products to 8% on diamonds (Annex D).

The Bill is currently the most critical issue affecting the mining sector. The bill has been the subject of controversy since it was first introduced in 2003, following the submission to Parliament of the Minerals and Petroleum Resources Development Act of 2002 (passed in 2004), which transferred to the State sovereignty and control over all mineral resources in South Africa. Ownership of
mineral resources had formerly been subject to a complex and overlapping web of private, tribal, provincial and national ownership and control. As the owner and custodian of the nation’s mineral resources, the State claims the right to charge a fee for exploitation of those resources - the principle underpinning the Royalty Bill.

The debate over the Royalty Bill has centered on the question of the basis for assessment of the royalty rather than the principle itself, which the industry has, for the most part, accepted. As Box 6 illustrates, Australia’s different state and territorial jurisdictions apply a wide range of mineral royalties, including specific rates, ad valorem royalties based on production or turnover, and other royalties based on profits. Both Australian and Canadian law recognizes that the state and its designees (i.e. provincial or state governments) possess the sole right to license (and be compensated for) use of mineral resources deemed to belong to the nation as a whole.

In Canada, as Table 9 shows, different provinces and territories also set their own royalties, which until the new tax structure was introduced in 2003, and unlike the proposed royalties for South Africa, were not deductible from Federal income taxes. This new deductibility feature replaces a previous 25% federal credit meant to compensate for the lack of deductibility. There is little to suggest that differences in mining royalties among Canadian or Australian provinces and territories have resulted in any significant changes in investment patterns. A recent study21 showed that South Africa’s mining industry ranked in the lowest quartile for Total Effective Tax Rate of gold, and in the second-lowest quartile for taxation of base metals mining, behind Western Australia, but considerably better than the United States (Arizona), Canada (Ontario), Papua New Guinea, and Ghana.

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Table 9. Provincial Mining Royalties, Canada

<table>
<thead>
<tr>
<th></th>
<th>Alberta</th>
<th>Yukon</th>
<th>Newfoundland &amp; Labrador</th>
<th>Northwest Territories</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold</td>
<td>5% ad valorem</td>
<td>$0.375 per ounce</td>
<td>For all minerals:</td>
<td>For all minerals</td>
</tr>
</tbody>
</table>
| Diamond        | Greater of 1% of gross production or 12% of net revenue* | Same as base metals      | 15% on taxable income + 20% secondary tax on royalties paid to Private 3rd party;  
|                |                    |                            | Special royalty of $0.22 per ton for ore from Wabush mines;  
| Base metals    | Greater of 1% of gross production or 12% of net revenue* | 3% on profit up to $1m; rises to 6% on profit over $10m, further 1% on each additional $5m, no maximum | Special 5% royalty on profits paid by Iron Ore Co. of Canada for production from Labrador City mines | 3% ad valorem on production up to $1 million, 5% on revenues from $1m to $5 m, increasing 1% for each $5 m up to maximum 12% for all minerals. Exemption for 1st 3 years of commercial production |

* Net Revenue is equivalent to net pre-tax profit

Some observers, including the South African industry, argue that imposition of a turnover-based mineral royalty will make the industry uncompetitive relative to other countries. The South African Competition Commission argues that the mining royalty is based at least in part on the perception by the Treasury that the mining industry pays less than its fair share of taxes, as demonstrated by the decline in average taxes paid from 6.7% of gross revenue in 1990 to 1.5% in 2001. The Competition Commission maintains that this decline is attributable to the declining profitability of much of South Africa’s mining sector, which they in turn attribute to the rising cost of production as mineral reserves (especially in the gold sector) are depleted.22

According to some reports, there are at least 3,00023 cases pending before the courts related to claims of expropriation of mineral rights (the Minerals and Petroleum Resources Act No. 28 of 2002 guarantees compensation for this). Though there is plenty of domestic and international precedent for imposition of turnover-based mineral royalties, the situation of Implats and of other companies

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22 “Comments by the Competition Commission on the Mineral and Petroleum Royalty Bill”, informal note.

23 Creamer Media’s Mining Weekly Online: www.miningweekly.co.za, 28th September 2005
in a similar position suggests that the State should, at a minimum, adjudicate these pending cases, compensate prior mineral rights holders, and dissolve existing royalty agreements before imposing a new royalty regime on the mining sector.

### Box 6. Mining royalties in Australia

In Australia, each state or territory sets its own system. Western Australia, for example, has a complex system of mineral royalties that include specific rates (i.e., a fee per ton, usually applied to low value construction or building materials), ad valorem rates (a percentage of sales value, less some allowances for transport costs), and profit-based systems based on the net profit of a mine. In some cases these systems are used in combination; a combined ad valorem and net profit royalty is applied to the Argyle Diamond and Ellendale Diamond projects with a net profit royalty of 22.5% calculated over the life of the project and a minimum 7.5% ad valorem royalty in any given year.

Although complex variations exist, the basic ad valorem royalty scheme consists of:
- 7.5% royalty on bulk materials
- 5.0% royalty on concentrates
- 2.5% on refined metal

For gold mining, the tax code reduced the royalty by half, to 1.25%, in any quarter in which the average spot price was less than A$450 per ounce. This provision expired in June 2005, but the tax code still exempts from royalties the first 2500 ounces produced by any single mine. Most minerals are, in fact, subject to ad valorem royalties. Queensland also applies a combination of specific and ad valorem.

Northern Territory, in its Mineral Royalty Act of March 31, 2005, introduces a uniform 18% mineral royalty based on net profits, as per the formula:

\[ GR - (OC + CRD + EEE + AD) \]

where GR is gross revenue; OC is operating costs; CRD is the capital deduction (a limited form of accelerated depreciation); EEE is any eligible exploration expenditure, and AD is certain additional deductions granted to a mine on the first year in which it enters production.

The foregoing examples of substantially divergent royalty schemes in different Australian states and territories indicate that ad valorem mineral royalties are not, of themselves, anti-competitive, since Australia is widely considered to have one of the most competitive mining sectors in the world. International best practices certainly do not rule out royalties of this kind, but they must take place within the context of an overall tax system that is favorable to investment in the mining sector.

**Sources:** Western Australia Department of Industry and Resources, Government of the Northern Territory, Queensland Bureau of Mining and Petroleum
Analysis of the Tax Regime

Ring-Fencing

Though the principle of ring-fencing as a tool to separate legitimate business activities from other activities that may be undertaken with the sole purpose of generating a usable tax loss is unexceptionable, its application in the mining sector is somewhat more suspect. Capital ring-fencing was introduced in South Africa in the 1980s because many new mines were being developed and the government wanted to prevent its entire mining tax base from being eroded by capital exemptions that could, if transferred among mining properties belonging to the same company, could reduce an entire company’s taxable income to zero.

The effect of ring-fencing is to reduce the value of capital exemptions by limiting their application to earnings from the mine at which the expenditures were incurred. Even with unlimited carry-forwards, if the mine operator must wait 10 years or more, in many cases, for a mine to generate sufficient profits against which the exemptions can be offset, the present value of those exemptions may be eroded by 80% or more. This constitutes a disincentive to new investment. As applied in the mining sector, however, ring-fencing creates artificial barriers between closely-related activities undertaken by the same company for the same purpose. When it was introduced in 1983, the mining industry was in a phase of rapid development and large investments and the Treasury feared that without ring-fencing it could see almost all taxable income from profitable mines offset by capital expenditures on mines that were as yet unprofitable. These conditions no longer apply in South Africa’s mining industry and to preserve them is likely to create disincentives to further investment.

As a 1998 White Paper on minerals and mining policy prepared for the Department of Minerals and Energy recommended that "the tax system should not discourage, in particular through ring-fencing, the use of the financial strengths of an existing company to invest in the establishment of new mines."  

Taxation of the Gold Industry

While exempting the income from marginally profitable mines, the gold mining formula applies a fairly high marginal tax rate to the taxable income of mines, though the capital exemption can keep taxable income low. For a company electing the STC exemption, the marginal tax rate is 45% on every rand of profit in excess of the 5% tax tunnel protection. This translates into average tax rates as shown in Table 10. Gold mining companies, however, are also taxed at a much lower rate.

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higher rate of 37% on non-mining income. This applies only to companies that have elected the STC exemption.

Table 10. Average tax rates for STC-exempt gold mining companies

<table>
<thead>
<tr>
<th>P/R ratio</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
<th>30</th>
<th>35</th>
<th>40</th>
<th>45</th>
<th>50</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avg. tax rate</td>
<td>0.00</td>
<td>22.50</td>
<td>30.00</td>
<td>33.75</td>
<td>36.00</td>
<td>37.50</td>
<td>38.57</td>
<td>39.38</td>
<td>40.00</td>
<td>40.50</td>
</tr>
</tbody>
</table>

Source: AngloGold Ashanti, 2005

The tax on gold mining is, in effect, highly progressive, with relatively unprofitable mines paying a low average rate of tax, while more profitable mines pay a much higher average tax. This effect is compounded by the capital exemptions, since mines in early stages of development are likely to have much higher capital expenditures and thus much lower taxable income, (thus reducing their METR), while more mature mines are likely to spend relatively less on mine development or expansion and so will have much higher taxable income.

The gold formula was originally intended, in large part, to avoid this effect. By allowing generous capital exemptions and a steeply progressive tax burden, it was designed to encourage gold mines nearing the end of their useful life to undertake new investments in deeper shafts. Even if the cost of production from such expansions is high, the gold formula would reduce the tax burden for companies undertaking these investments.

The evidence is mixed as to whether the gold formula has produced the intended effect of stimulating investment in marginal mines. South Africa’s gold production has declined by an average of 4% annually since 1970, when it peaked at 1000 MT; 2004 production fell to 342.7 MT, the lowest level since 1931. The gold formula has probably done little to halt or reverse the decline of gold mining, but the decline might have been swifter had the gold formula not been in place.

South Africa is the highest-cost gold producer in the world. Much of this is due to geology: South African gold mines are the deepest in the world, and production costs increase exponentially as depth increases. The cost structure and profitability of South Africa’s gold industry are uniquely vulnerable to changes in the exchange rate, since gold still accounts for nearly 14% of the country’s merchandise exports. Though international gold prices are at 20-year highs, they have done little to mitigate the effects of high production costs; indeed, since the

value of the rand tends to increase with the dollar price of gold, the dollar cost of production also increases.

Many of the gold industry’s principal inputs have increased faster than the basic inflation rate\(^{26}\) (including water, steel, rail transport and wages). The Chamber of Mines estimate that the overall gold production costs (excluding capital expenditure) rose by 13.4% from 2003 to 2004. The Chamber also estimate that ten of South Africa’s biggest mines, employing some 90,000 people and accounting for about half of national gold production, are marginal or loss-making given the current cost structure.

The Chamber also argues that to measure the METR in a single year is misleading. During times of high rand gold prices, the industry pays a disproportionately higher percentage of its earnings than the corporate sector in general, while in times of low rand prices the gold sector pays less (Table 11 refers). During the boom period of the mid 1970s to the mid-1980s, gold mining companies on average paid nearly 48% of their operating profit as tax, while over the past 10 years – and in 2004 the industry incurred an aggregate net loss before capital expenditure for the first time in over 50 years – it paid a much lower share.

The gold formula thus shields mining companies from the worst effects of low rand gold prices and probably prevents or delays the closure of many marginal mines. The question however, is why gold mining (as opposed to all mining) should benefit from such a provision.

Though protection of declining industries is not necessarily advisable, the social and economic importance of gold mining in South Africa suggests that its decline needs to be managed carefully. This general conclusion would suggest that the gold formula needs to be re-validated in light of a changing policy environment for mining in general and gold mining in particular.

**Table 11. Historical Comparison of Gold Sector Tax Burden 1975-2004**

<table>
<thead>
<tr>
<th></th>
<th>Taxes as % of Value Added</th>
<th>Taxes as % of Operating Profit</th>
<th>Pre-capex profit-revenue ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975-1984</td>
<td>32.91</td>
<td>47.72</td>
<td>50.64</td>
</tr>
<tr>
<td>1985-1994</td>
<td>16.58</td>
<td>32.35</td>
<td>31.69</td>
</tr>
<tr>
<td>1995-2004</td>
<td>4.86</td>
<td>13.22</td>
<td>15.26</td>
</tr>
</tbody>
</table>

Source: South African Chamber of Mines

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\(^{26}\) Producer price inflation at the time of this study (October 2005) was 3.7%.
Diamond Industry

The South African Chamber of Mines are, predictably, concerned about the contents of any new tax legislation. They have argued that very heavy export taxes could result in job losses of 8,500 in diamond mining, while creating at most 1,500 to 2,000 new jobs in diamond cutting and polishing.

This is due in large part to the gap in productivity between South African diamond beneficiation (an industry that currently employs at most 7,000 people) and India, which has created a huge industry focused on smaller and less valuable stones, which employs an estimated 900,000 workers at a fraction of the cost of South African cutters. According to former De Beers CEO Gary Ralfe, “In India, the average cost of cutting a carat of diamond is less than $10 a carat. In South Africa it is around $30 a carat.”

Consequently, in South Africa it is likely to be economically viable to process only the larger, higher-value stones of which labor represent a smaller fraction of the total value of the final product. Domestic demand for higher-value stones until now has largely been satisfied by De Beers’ arrangement with South African sightholders. Any significant duty on rough diamond exports would be likely to reduce international (especially Indian) demand for smaller diamonds, which cannot be cut economically in South Africa. Since profit margins are much lower on smaller diamonds, any price increase would likely cause Indian cutters to source rough diamonds from other countries.

Some industries derive considerable competitive advantage from their proximity to raw materials, but diamond cutting and polishing is not one of them. Proximity to diamond mines in no way contributes to the competitiveness of diamond processing industries.

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Box 7. Canadian Mining Taxes

In Canada, the mining industry receives special treatment from both federal and provincial/territorial corporate income tax regimes. Canada in 2003 introduced a new mining taxation system, phased in over five years, and intended to make mining taxation more compatible with the reduced general corporate income tax rate while also preserving, simplifying and harmonizing mining tax incentives.

Corporate Income Tax will fall from 27% in 2003 to 21% in 2007
The Deductible percentage of existing 25% resource allowance will fall from 90% to 0%
New tax credit for mineral exploration in Canada will rise from 5% to 10%
Provinces impose a CIT as well, ranging from around 10% to 17%.

The Accelerated Depreciation Allowance (ADA) allows 100% expensing for assets acquired before the beginning of commercial production, or for major expansions, or for the portion of investment expenditures in excess of 5% of gross income from the mine. The combination of CCA and ADA creates a more attractive incentive for mining investment than the South African gold formula because it includes an entire class of assets that is excluded from the South African capital depreciation allowances. The Resource Allowance is a 25% deduction from taxable income intended to compensate mining companies for the non-deductibility of provincial and territorial royalties and taxes, but this will be entirely phased out by 2007 and replaced by full deductibility of provincial royalties and taxes.

Investment Tax Credit: The new mining tax code provides a 10% tax credit for mineral exploration and pre-production activities.

According to the Canadian Government, “establishing a common statutory federal rate of corporate income tax for all sectors and treating costs more consistently, both across resource projects and between the resource sector and other sectors of the economy, will promote the efficient development of Canada’s resource base. It will also improve the international competitiveness of the Canadian resource sector.” The government projects that the new mining tax structure will substantially reduce the METR on the mining sector:

A key feature of the tax reform, which applies to all sectors, is the phased elimination of the federal capital tax, a sort of minimum alternative tax for large companies, levied on the amount by which a corporation’s taxable capital employed in Canada exceeds C$10 million. Canada’s METR on mining, already low at 10.4%, will further decline to 7.6%

Source: Natural Resources, Canada
Effective Tax Rate

At just above 0% mining faces the lowest overall weighted average METR on capital of the sectors studied. There are two reasons for this. First, the gold formula substantially lowers the CIT rate. Moreover, depending upon their election of the formula, in some cases gold mines do not have to pay the STC on dividend distributions. The METR calculations in Table 6 reflect a weighted average of gold and other mining companies, where it assumed that the ratio of taxable income to turnover to gold mining companies is 12% and that gold companies account for 40% of mine investment.

Second, the ability of mining companies to immediately write-off all machinery and equipment as well as mine development expenditures. 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.

The calculations in Table 6 ignore the ring-fencing provision and assume that capital allowances can be claimed immediately. Incorporating loss carry-forwards and ring fencing is very difficult to analyze using METR analysis. However, it is typically found that METRs calculated ignoring ring fencing are a good approximation of the marginal tax burden. Depending upon the income profile from the mine, the METR may go either up or down relative to the full taxpaying scenario.

Another issue concerns the imposition of royalties or severance taxes on mine turnover. As an illustrative exercise we also calculated METRs on mine capital under the imposition of a 4% gross royalty. It is assumed in the calculations that this royalty would be deductible for CIT purposes. In the presence of a 4% royalty on turnover the METRs on capital for mining are as follows:

<table>
<thead>
<tr>
<th>Capital Type</th>
<th>METR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and Equipment</td>
<td>2.9%</td>
</tr>
<tr>
<td>Buildings</td>
<td>30.6%</td>
</tr>
<tr>
<td>Land</td>
<td>8.8%</td>
</tr>
<tr>
<td>Inventories</td>
<td>34.0%</td>
</tr>
<tr>
<td>Total</td>
<td>17.4%</td>
</tr>
</tbody>
</table>

This simulation suggests that the imposition of a royalty on mine turnover has a significant impact on the METR on mine capital. While for the simulation of a 4% gross royalty the METR on mine capital increases to be in line with METRs on other sectors (though is still near the low end), higher royalty rates would obviously result in higher METRs for the mine sector.
Concerns about the low contribution of mining to the fiscus may be misplaced. The calculations are based on FY2004/2005 results, possibly the worst year on record for South Africa’s mining sector, and the worst year for the gold sector in 73 years. Returns in South Africa’s mining sector are volatile. Much of this has to do with the vulnerability of the rand gold price to external factors, especially the rand/dollar exchange rate which has been affected by wide swings in value. The weight of mining relative to the overall South African economy is such that the rand tends to appreciate when international (dollar-denominated) mineral prices are high and depreciate when they are low. So, paradoxically, boom times for the global mining industry are often the worst years for the South African mining sector.

The mining has in the past contributed a far greater share of total tax receipts and could do so again, depending on two external factors: international minerals prices and the value of the rand relative to the dollar and other major currencies. It could be a mistake to make substantial changes in tax policies affecting a key sector of the economy on the basis of perceived trends that may, with some historical perspective, turn out not to have been trends at all.

Mining tax regimes abound in different and special treatment for different kinds of activities and different kinds of minerals, but there is an observable trend towards greater simplification and standardization. In Canada, each province has its own separate tax code for mining, and they vary substantially. It is noteworthy, though, that the Northwest Territories, which have the newest mining tax code, passed in March 2005, abolishes different royalty schedules for different categories of minerals in favor of a single schedule applicable to all minerals.

**Recommendations**

- Avoid reactionary tax changes in response to the mining sector’s low METR and low effective average rate of tax as it stands today. The effective tax rate for mining companies is more volatile than in other sectors, largely because of the sector’s vulnerability to external forces. Though the METR is low now, it will rise as and when rand mineral prices rise. At the same time, the industry’s METR does not appear so high as to diminish the mining industry’s competitiveness, nor is it likely to even as it rises as a function of increased rand mineral prices.

- There is little to suggest that imposing royalties as outlined in proposed legislation will render South Africa’s mining industry uncompetitive. The proposal by government has a clear and defensible logic and is consistent with practices in many other countries.
• However, there is a need to resolve existing Royalty Agreements. Many mining companies are currently paying mineral royalties to tribes and private landowners. Before mining companies begin to pay royalties under the new system, claims for compensation for mineral rights taken by the state should be adjudicated and the legal way should be made clear for mining companies to extricate themselves from existing royalty agreements.

• Review Proposed Coal Royalties: The mining industry and others have expressed concern about the proposed 2% royalty on coal, which is South Africa’s principal source of electricity. This royalty could translate into higher energy costs, depriving South Africa of a key competitive advantage, which could have negative consequences for future FDI flows and tax revenues. South Africa could follow the example of Western Australia, which imposes a $1 per ton levy on coal for domestic consumption and a 7.5% ad valorem royalty on exported coal.

• Alleviate Initial Royalty Burden: Tax policy in respect of the mining sector should focus on managing a mature industry and maximizing tax revenues through the right combination of levies and incentives, rather than on trying to stimulate substantial new investment. To reduce any excessive burden on newer mines or mining companies, South Africa could adopt the practice (applied in Canada’s Northwest Territories) of exempting the first three years after a mine’s entry into commercial production before the royalty is applied.

• Re-evaluate the continued justification for the Gold Formula. There were good historical reasons for its initial introduction, but its continuing value must be assessed in the context of the future potential of the gold industry and of the industry’s importance in the South African economy. Recognizing that the gold mining sector employs a great number of people, there may be an argument for some sort of continued support, but this needs to be justified ex ante.

• Reduce Ring-Fencing: Ring-fencing is the one crucial area in which South Africa’s mining tax policy is at odds with international practices and threatens to make the industry less competitive over time.
Box 8. Flow-Through Shares: Shifting mining tax deductions to outside investors

Canada has a financing mechanism called flow-through shares (FTS), which make it easier for a company to obtain financing for expenditures on mineral exploration and development.

By issuing flow-through shares, a company can pass on, or “flow through,” certain expenses to the purchaser of the share (which can be an individual or a company), allowing these expenses to be claimed as a tax deduction by the investor and not the company. This reduces the investor’s tax liability by allowing him to claim tax deductions which the mining company, with little or no taxable income, could not. The FTS mechanism, therefore, allows costs to be claimed sooner than they would have been if they were retained in the corporation incurring them, but also to be claimed against income subject to higher marginal rates.

For individual investors, the advantages of investing in flow-through shares can be twofold: (i) they receive a 100% tax deduction for the amount of money they invested in the shares, and (2) the value of their investment will increase if the exploration is successful.

The FTS has, apparently, been a successful investment incentive. According to the Canadian Government, flow-through shares have financed over C$350 million in exploration from 2002 to 2005, including some large gold, copper, nickel and diamond projects now under development.

Source: Natural Resources Canada

Manufacturing

Manufacturing in South Africa has experienced a difficult transformation process since 1994. There has been only marginal growth in output during the 1990s. The re-introduction of South Africa to the global economy, through the removal of sanctions and entry to the World Trade Organization, has created both threats and opportunities for the sector. Of all the countries in the region, South Africa has the largest manufacturing sector. It includes both declining industries such as textiles, as well as growth sectors such as agro-processing and boat building. The motor industry is especially successful but dependent upon a generous incentive scheme (see Box 9).
Summary of tax and incentives in the manufacturing sector

The following are the main tax parameters available to the manufacturing sector.

Corporate income tax

The standard rate of 29% corporate profit tax applies, as does the Secondary Tax on Companies, of 12.5%.

- Income tax allowances

- The tax code allows investors to accelerate the depreciation of new capital equipment over four years. The schedule is 40-20-20-20.

- Wear and tear is normally not allowed on buildings. However, an annual allowance equal to 5% (20 year straight-line) of the cost of industrial buildings or of improvements to existing industrial buildings is granted. (This allowance was increased to 10% for industrial buildings erected between 1 July 1996 and 30 September 1999 and brought into use before 31 March 2000).

- Small business allowances for manufacturing firms

- As with any small business, if the annual turnover of the business is below R35,000 the rate of corporate tax is 0% and below R250,000 turnover then corporate tax is 15%.

- Further, small businesses may deduct 100% of the cost of any plant or machinery brought into use for the first time and used in a process of manufacture or a process of a similar nature.

Value Added Tax

Value Added Tax applies uniformly to the sector, including the zero rating of export sales.

Small businesses (manufacturing or otherwise) may not register for VAT if they have an annual turnover below R20,000. With a turnover above this figure firms may choose to register for VAT voluntarily, and above R300,000 annual turnover VAT registration is compulsory. (See Small Business Section for more information).
The Tax and Incentive Regime in Practice

Manufacturing enterprises welcomed the recent reduction of corporate income tax from 30% to 29%. However, they uniformly complain about the amount of other taxes levied on revenue (e.g. the skills development levy, unemployment insurance, regional services levy, etc).

The accelerated depreciation allowance and 5% wear and tear allowance on industrial building make a modest contribution to the decision to invest.

Very large manufacturing enterprises benefit from incentives (by accessing the SIP or MIDP) as do very small enterprises (small enough to benefit from the small business regime). Between these two extremes, there are no specific incentives.

Customs and excise duties

Manufacturing firms tend to rely more heavily on imports of inputs and capital equipment than other sectors. Customs excise duties therefore play an important role in the overall tax burden in this sector.

The average nominal tariff (applied outside of the SACU zone) on imports is 11.4%. Yet, the extent of exemptions is such that the effective rate is 3.5%.29

The differential between nominal and applied rates of duty on inputs and capital equipment is substantial and reflects a non-uniform application of duties. i.e. a lot of exemptions, duty drawback schemes and imports to IDZs.

Duty Drawback Scheme

Duty drawback is a mechanism whereby duties paid on imported inputs that are subsequently used for the production of goods for export are repaid. The rationale for the arrangements is to eliminate the burden of duties from input prices of domestic production that is exported. 30

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29 IMF (2005) South Africa: Selected Issues
30 A duty drawback scheme succeeds in providing imported inputs to the exporter at world prices. However, it does not succeed in eliminating the impact of tariff protection on the domestic price of non-tradable goods; only a general reduction of import tariffs can do that.
Industrial Development Zones (IDZ’s)

There are five designated IDZs, designed to encourage international competitiveness in South Africa’s manufacturing sector. Not all are currently active.

Manufacturing exporters within IDZs may import raw materials and capital duty and VAT free.

**Analysis**

The manufacturing sector faces an overall weighted average aggregate METR on capital of 21%. Because of the availability of accelerated depreciation, at 14% equipment bears a slightly lower METR than buildings. Without the accelerated allowance, the METR on equipment in manufacturing would be seven percentage points higher, at 21%, and the overall weighted average METR on manufacturing capital would rise four percentage points to 25%. The METR on inventory capital is quite high at 32% because of the use of FIFO accounting.

We have also undertaken an alternative set of calculations for the manufacturing sector under the assumption that the firm benefits from the SMEDP, from the SIP at 50% and the SIP at 100% (Table 12).

**Table 12. How Incentives in the Manufacturing Sector Affect the METR**

<table>
<thead>
<tr>
<th></th>
<th>SMEDP*</th>
<th>SIP (50%)</th>
<th>SIP (100%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and</td>
<td>-301.1%</td>
<td>-117.96%</td>
<td>-252.20%</td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>-12.6%</td>
<td>-32.60%</td>
<td>-99.60%</td>
</tr>
<tr>
<td>Land</td>
<td>5.3%</td>
<td>5.29%</td>
<td>5.29%</td>
</tr>
<tr>
<td>Inventories</td>
<td>32.4%</td>
<td>32.41%</td>
<td>32.41%</td>
</tr>
<tr>
<td>Total</td>
<td>-51.1%</td>
<td>-62.40%</td>
<td>-151.89%</td>
</tr>
</tbody>
</table>

*Assuming applied at the maximum 10% level. Also assumes the program caps are not binding.

Table 12 shows that the SMEDP and SIP have a very substantial impact on capital METRs. In particular, the negative METRs on machinery and equipment (ranging from -118% to -301%) reflects an extreme subsidy at the margin. This means that investments that would not have been undertaken even in the absence of taxes altogether, will be undertaken in the presence of the SMEDP.

While the full review of the SMEDP and SIP is pending, it would appear from firm level interviews and the METR analysis that SIP did attract additional capital investment that may well have gone elsewhere, or been delayed. The key questions (given the size of the subsidy) however are (a) at what cost, and (b)
whether SIP investments were in the key sectors targeted at a national or provincial level.

The METR results for small manufacturing firms (Table 6, 9 and 10) provide interesting insight. They highlight the importance of VAT for the overall tax on capital. Despite the 0% corporate income tax benefit, if a small manufacturer is not VAT registered and therefore unable to claim back input credits, the overall METR is as high as 32%.

**Other Issues**

Both the auto and textiles sectors benefit from industry specific incentives. ‘Credits’ against import duty are earned in return for exports. The auto industry has thrived under this system; the textile sector has not (See Box 9).

Small, growing, manufacturing firms face a particular problem with accrual basis of taxation because they carry significant inventories. This places a special burden on VAT and CIT payments in terms of cash flow.

Under the VAT Act of 1991 (Section 15) sole proprietors with a turnover of less than R2.5 million may use cash rather than accrual accounting (tax based on ‘payments’ not ‘invoices’) for calculating VAT payable. This is most likely to benefit farmers, who are less likely to incorporate than manufacturing firms are. Further, the scheme does not extend to corporate income tax.

Given the cash flow problems many small manufacturing firms face with a growing inventory, the extension of cash accounting could usefully benefit them. A move from FIFO to LIFO accounting would assist all manufacturers, and especially small ones, by lowering the tax on this component of capital.

Similarly, a move from FIFO to LIFO accounting would help growing businesses who have a lot of capital tied up in inventory.
Box 9. The Motor Industry Development Program, the Textile Duty Credit Certification Scheme and the Strategic Investment Program

The Motor Industry Development Program (MIDP) was initiated in 1995. It included a phasing down of tariffs; removal of local content requirements; duty-free imports of components up to 27% of the wholesale value of the vehicle; and duty rebate credits earned on exports. Auto exporters either may use duty credits to import local content duty-free, or sell them as a separate source of revenue. Many, but not all, commentators have hailed the MIDP as a success, having achieved significant growth in vehicle imports and exports, as well as substantial investments by major vehicle manufacturers such as BMW, Volkswagen and Toyota.

Since 1994, textile tariffs have significantly reduced with average tariffs for yarn falling from 50% to 22% in 2003. In addition, clothing producers have been able to import yarn, fiber or fabrics on a duty free basis. An explicit export incentive, known as the Duty Credit Certificate Scheme (DCCS), was introduced to coincide with the phase down and this was subsequently extended to the end of 2005. The DCCS allow firms to claim a remission of duty for proven exports. The level of support depends on the product exported – with highest support for clothing followed by fabric and then yarn. There is greater support for firms exporting more than 15% of their turnover. The DCCS has been less successful than the MIDP and has failed to stem the decline of the industry, principally due to differences in the structure of the industry and the ending of the Multi-Fiber Agreement, hailing a new era of intensive international competition.

The Strategic Investment Program (SIP) was introduced in November 2001. Qualification provides an initial capital allowance (ICA) of 50% or 100%, depending on the qualifying points score. Projects must have a capital investment of at least R50 million and further points are awarded for the ‘fit’ of the project to strategic goals and employment creation. The ICA is additional to the normal accelerated depreciation. As companies are able to carry forward paper losses, the combined result is that companies operating under the SIP can operate in a tax-free environment for many years. The SIP imposes a ceiling (up to R600m.) on the cost of the industrial assets that may qualify for the ICA for any one project. Apart from this, the law sets a ceiling of R3 billion on the cumulative amount of ICA benefits that can be granted under the program – which has now been reached. The qualifying criteria are explicit and substantive, applications are gazetted, awards are reported annually, and revenue costs have to be monitored. The SIP is very attractive to investors; the initial allowance substantially lowers the Marginal Effective Tax Rate.

**Recommendations**

- In the review of the Strategic Investment Program and the SMEDP, and the drafting of any subsequent replacements, carefully assess the METR to ensure that the incentive does not create a subsidy across the firm as a whole. Investment incentives, if any, should aim for a significant reduction in the METR of the marginal investment only.
- Consider the extension of cash accounting for VAT purposes to incorporated small businesses. Further, investigate the extension of cash accounting for corporate income tax as well VAT for small businesses (while accepting the opportunities for abuse that this creates).
- Further help emerging manufacturing businesses by moving from FIFO to LIFO accounting.
- Reduce the differential between nominal and effective rates of duty on inputs and capital equipment. Implement policies to bring these more into line by, for example, reducing the number of tariff bands and tariff peaks.

**Tourism**

In 2005 South Africa’s tourism industry is expected to generate 3.9% of GDP and 522,000 jobs directly, while the broader direct and indirect travel and tourism economy is expected to generate 9% and 1.1 million jobs. Travel and tourism demand expects real growth of 7.1% in 2005.31

**Summary of the tax and incentive regime**

**Corporate tax**

All the standard features of the corporate income tax regime apply to the tourism sector, including the reduced rates for small businesses and the Secondary Tax on Companies.

The tourism sector benefits from a slightly accelerated depreciation schedule on buildings.

- An annual 5% allowance on new and refurbished hotel buildings
- An allowance of 20% for improvements, which do not extend beyond the exterior framework of the building on buildings built on or after 17 March 1993.
Value Added Tax

The standard VAT rate of 14% is applicable to most services offered in the tourism industry. However, some services are zero-rated and some exempt.

The following are VAT exempt:

- The local transportation of fare paying tourists in vehicles, other than game viewing vehicles. This applies to tour operators, ground handlers, wheels operators, and includes day tours, airport transfers, country tours, chauffeur drive services, etc.

The following are zero-rated:

- The transport portion of cross-country tour provided by an operator, which takes place outside of South Africa. This is applicable to ground handlers, overland operators, tour operators and wheels operators for cross border tours.

- The service associated with the packaging and selling of a tour or package sold to a non-resident tourist who is outside of the country at the time the package is sold.

- The head office services offered by a hotel/lodge management company based in South Africa to properties managed by them outside of South Africa.

- The service associated with the arranging of the international transport of passengers by road, rail and air. This is applicable to tour operator and travel agent commissions and fees for the arranging of such travel.

Service charges are not compulsory in South Africa and are at the sole discretion of the consumer.

Incentives

Many tourism operators also take advantage of the Small to Medium Enterprise Development Program (SMEDP), which applies to providers of short-term accommodation (hotels, lodges, bed and breakfasts) and tour operators in the tourism industry. The program provides investments of up to R100 million with a tax free cash grant for two years on the cost of the investment in buildings, furniture, equipment and vehicles (third year is dependant on a payroll cost percentage of at least 30% of turnover). The maximum grant is 10% per annum.
South Africa also has various other non-taxed tourism based support programs on a national and regional level. These include trade fair support, business linkages, access to finance, access to markets, marketing assistance, training assistance support, mentorship programs, etc.

**Duties and Excises**

Import duties, unlike in many other African countries, have a limited impact on the tourism industry in South Africa due to the significant amount of capital equipment, furniture, fixtures, equipment, etc produced locally.

South Africa forms part of the Southern African Customs Union (SACU) with Botswana, Lesotho, Swaziland and Namibia allowing free trade between these countries. In addition, there are trade agreements with the Southern African Development Community (SADC) and the European Union (EU), which are in different stages of implementation. South Africa has, to a large degree, phased out customs duties with SADC and is in the process of doing so with the EU. Table 13 shows some of the most relevant and applicable customs duties from a tourism perspective:

**Table 13. South African Customs Duties**

<table>
<thead>
<tr>
<th>Community</th>
<th>Malt Beer</th>
<th>Spirits</th>
<th>Motor Cars</th>
<th>Tour buses</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>5%</td>
<td>154 c/l</td>
<td>34%</td>
<td>20%</td>
</tr>
<tr>
<td>EU</td>
<td>Free</td>
<td>135.52c/l</td>
<td>34%</td>
<td>15%</td>
</tr>
<tr>
<td>SADC</td>
<td>Free</td>
<td>Free</td>
<td>20%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Excise duties are low compared to other international destinations. Prices of the major excisable goods in the tourism industry (beer, wine and spirits) are some of the lowest in the world. This is in contracts to many other tourist destinations in Africa (Table 14).

**Table 14. South Africa and Regional Excise Duties**

<table>
<thead>
<tr>
<th>Country</th>
<th>Malt Beer</th>
<th>Wines</th>
<th>Spirits</th>
<th>Cigarettes</th>
<th>Petrol</th>
<th>Diesel</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>23%*</td>
<td>140c/l</td>
<td>&lt;50%*</td>
<td>252c/10</td>
<td>3.91c/l</td>
<td>3.8c/l</td>
</tr>
<tr>
<td>Zambia</td>
<td>70%</td>
<td>125%</td>
<td>125%</td>
<td>115%</td>
<td>60%</td>
<td>30%</td>
</tr>
<tr>
<td>Malawi</td>
<td>65%</td>
<td>65%</td>
<td>65%</td>
<td>60%</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Kenya</td>
<td>Ksh38/l</td>
<td>45%</td>
<td>Ksh100/</td>
<td>0%</td>
<td>Ksh19/l</td>
<td>Ksh8.5/l</td>
</tr>
</tbody>
</table>

*Based on an average bottle of beer and the minimum price of a bottle of spirit. Source: Customs and Excise and government departments of South Africa, Malawi, Zimbabwe, Kenya and Tanzania.
Tourism Levy

Tourism related businesses may choose to collect a voluntary tourism levy equal to 1% percent on accommodation costs. This levy is transferred to the South African Tourism Board for use with international tourism marketing efforts. The levy is managed by the Tourism Business Council of South Africa (TBCSA).

A small number of members collect a large proportion of the levy collected through the voluntary tourism levy. Only 600, out of an estimated 30,000, tourism establishments, most of which are large organizations, collect the levy in the tourism industry. In 2004 the levy raised R48 million. To-date the levy has raised over R200 million, of which R180 million has been handed over to SA Tourism and used in marketing the country internationally. The Tourism Business Council of South Africa is continually trying to expand the membership and collection base and conducts annual tourism road shows explaining the concept.

Visas

The tourist visa policy in South Africa is conducive to growth whereby a large number of countries don’t require visas to visit South Africa. It is also specifically focused on facilitating increased tourism from South Africa’s main source markets. Some other countries in Southern Africa such as Botswana, Malawi and Namibia also have favorable visa laws, where citizens from UK, USA, Canada, Australia and most EU countries don’t require visas. However many countries still have very restrictive laws which are only relaxed if only done on a reciprocal basis. Countries such as Kenya, Tanzania, Zimbabwe and Zambia impose fairly restrictive traveling conditions, requiring visas from most countries and also at a relatively high cost, ranging from $30 - $70.

Airport Taxes

An international air departure tax of R60 and R120 is imposed on passengers departing to regional (SADC) and other all international destinations respectively. This tax is included in the price of the air ticket and paid over to SARS by the respective airlines.

Tax system in practice

Corporate Income Tax

For the tourism industry, the current rate of 29% is on par with competitor destinations in Africa. Only Botswana has a lower corporate tax rate than South
Botswana has also steadily reduced its tax rate over the past 15 years, from 40% in 1990 to 25% today.  

Table 15. Regional Comparison for South Africa’s Corporate Income Tax

<table>
<thead>
<tr>
<th>South Africa</th>
<th>Botswana</th>
<th>Namibia</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Malawi</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>29%</td>
<td>25%</td>
<td>35%</td>
<td>30%*</td>
<td>30%</td>
<td>30%**</td>
<td>35%</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Swaziland</td>
<td>Lesotho</td>
<td>Australia</td>
<td>Brazil</td>
<td>New Zealand</td>
<td>Thailand</td>
</tr>
<tr>
<td>32%</td>
<td>30%</td>
<td>35%</td>
<td>30%</td>
<td>34%***</td>
<td>33%</td>
<td>30%</td>
</tr>
</tbody>
</table>

*30% for resident companies, for non-resident companies’ tax rate is 37.5%  
*30% for resident companies, for non-resident company’s tax rate is 35%  
***15% corporate income tax, 10% surtax (on taxable profits exceeding +- US$ 82 000 and 9% social responsibility tax

For hotels, the low margins associated with the industry, together with the large capital-intensive nature the investments, results in the sector not paying a large amount of corporate tax. This is especially the case in the first 5-7 years of the business lifecycle when businesses are usually not profitable.

Corporate income tax affects service based tourism businesses (tour brokers, hotel management companies, travel agents, destination management organizations and tourism marketing companies) more. Large corporations and conglomerates, some of which are well established, dominate the tourism industry in South Africa, especially the tour operating and the hotel management sectors. These companies pay a significant tax burden due the profitable nature of their operations and their maturity. The 12.5% STC also affects these operations more than the smaller less established businesses.

There are an estimated 6,000 to 10,000 bed and breakfast operations in South Africa, a large proportion of which are informal. Of those formally registered as businesses, the majority operate as sole proprietors and largely unaware of the benefits and conditions of the small business tax regime.

Many South African hotel and tourism operators have Africa wide investments. In these situations taxes, without a double taxation agreement, South African companies face a double tax burden. In addition, where a double taxation agreement does exist, companies may only credit withholding taxes paid (for example) against income tax paid in South Africa relevant to the service provided. If that part of the company records a loss in South Africa, then the withholding tax is irrecoverable. The result is that South African based companies are

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32 Botswana Department of Taxes in the Ministry of Finance and Development Planning
relocating offshore to manage their interests in Africa (in countries which either have double taxation agreements or in countries which are tax free).

**Value Added Tax**

The VAT rate in South Africa is lower than most competitive countries in Africa, which helps make South Africa a competitively priced destination. However, in comparison to some of its major international long haul competitors such as Australia, Brazil and Thailand, the VAT rate is high, putting South Africa at a price disadvantage (Table 16).

**Table 16. South Africa VAT vis-à-vis Competitor Destinations**

<table>
<thead>
<tr>
<th>South Africa</th>
<th>Botswana</th>
<th>Namibia</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Malawi</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>14%</td>
<td>10%</td>
<td>15%</td>
<td>16%*</td>
<td>20%</td>
<td>17.5%</td>
<td>17.5%</td>
</tr>
<tr>
<td>Mozambique</td>
<td>Swaziland</td>
<td>Lesotho</td>
<td>Australia</td>
<td>Brazil</td>
<td>New Zealand</td>
<td>Thailand</td>
</tr>
<tr>
<td>17%</td>
<td>14%</td>
<td>14%***</td>
<td>10%</td>
<td>17%**</td>
<td>12.5%</td>
<td>7%</td>
</tr>
</tbody>
</table>

*A reduced rate of 14% applies to the restaurant and accommodation industries.

** Standard rate for items produced in same state, for items produced in other states rates are 7% and 12%

***15% on liquor, 5% on electricity and 14% on all other sales

There are a significant number of small businesses in the tourism sector (especially tour guides, tour operators and bed and breakfasts) which fall underneath the compulsory VAT threshold of R300, 000 and do not charge VAT. Many of these enterprises do not ‘opt in’ to the VAT system on a voluntary basis for the following reasons:

- A lack of understanding of the system;
- The inability to charge VAT onto the consumer due to the high price elasticity of demand, strong competition in the market and the lack of VAT charged by their competitors;
- The penalties for the non-payment of VAT are high which accounts for high compliance amongst registered businesses.

The VAT Act is being interpreted in many different ways, some of which seem to have little factual base. This difference stems partly from a lack of understanding of the Act and partly from some of the wording of the code, which is open to interpretation. One result is a high cost of compliance for companies (who spend considerable amounts annually on tax advice) and a high cost of collection for

33 A penalty equal to 10% of the amount due is payable if the VAT deadline is not met, in addition to daily interest charges for each late day.
SARS. The application of the VAT code by the Private sector also differs vastly among operators. Some operators, due to their uncertainty relating to the correct interpretation of the law are not applying the law in their favor.

Below are some of the examples of different interpretations and applications:

- Charging VAT on cross border transportation to multiple countries;
- Claiming that the entire tour package, including accommodation, transportation, meals, etc (not just the tour operator service) as zero-rated;
- Charging VAT on transport portions of packages;
- Charging VAT on day tours and other tours where a tour guide is included in the service.

SARS have attempted (with mixed success) to clarify these issues with practice notes and the adjustments of legislation. For example, Legislative Memorandum 1998, clause 88, adjusts the VAT Act to provide clarity on the definition of an export service and how it relates to a tour operator. Hence, the inclusion in the Act of the condition that services need to be provided to non-residents and that the persons consuming the service need to be outside the Republic at the point of consumption. This therefore excludes the hotel and other portions of the package from zero-rating, but allows for the zero-rating of the tour operator service, as long as it is provided to a non-resident outside of the country.

In our discussions with the Private sector, a vast majority found the VAT system complex, vague and difficult to understand and interpret. This is especially the case regarding the sale of multi-country packages where each item needs to be separated by country and the relevant VAT rate applied. In such cases, values need to be allocated to various elements of a package through transfer pricing, which is both subjective and complex. For example, how do you value the quality of the game drive and the game experience at a game lodge?

The main purpose of providing an exemption on the VAT on transport in developing countries is in order to encourage private sector operators to provide public transport and in order to reduce the price paid by consumers for substitute public transport. This VAT concession is usually offered in developing countries generally due to the country’s inability in to provide adequate public transport. The intention therefore was never to provide VAT concessions for the transportation of tourists. Over a number of years operators in the tourism industry have benefited from this exemption and until recently also benefited from the exemption on game drives.

Most countries in Africa and other competitive tourism destinations treat VAT on transportation and export supplies in a similar manner. Some however try and restrict transportation purely to providing “substitute public transport” by imposing restrictions relating to the capacity of vehicles (14 seats or more in
Rwanda are exempt) and relating to tourism vehicles (which are excluded in Namibia). Both of these examples open themselves up for manipulation and are far more difficult to track, monitor and administer, especially relating to operators who use various sizes of vehicles and who provide both tourist and public transport services.

The wording used in some of the other comparative countries in Africa and elsewhere relating to these subjects is in some cases is very similar and vague, whilst in others is more defined and specific. The intentions of these laws need to be made clear and the definitions need to be expanded and clarified in order to reduce manipulation and limit doubt.

**Table 17. Regional and International Solutions to the VAT and Transport Issue**

<table>
<thead>
<tr>
<th>Country</th>
<th>Treatment and Wording</th>
</tr>
</thead>
</table>
| Kenya      | “Exemption on tour operator and travel agency services including hotel, travel, holiday and other supplies made to travelers excluding services provided for commission other than commission earned on air ticketing”  
             | “Transportation of passengers by any means of conveyance, excluding where the means is hired or chartered”                                                                                                           |
| Namibia    | The provision of public transport is exempt of VAT and is defined as “the supply by any person (other than a tour operator) of transport by road, air, sea or railway,  
             | provided directly to that person to fare-paying passengers                                                                                                                                                    |
| Lesotho    | Zero rating on transport is applicable to “international transport passengers originating in Lesotho with a destination outside Lesotho”                                                                                           |
| Botswana   | International transport of passengers is zero rated  
             | Services physically rendered outside of Botswana are zero rated and services to non-residents if the services are supplied whilst they are outside of the country |
| Australia  | Exports of goods and services to non-residents of Australia who are not in Australia when the supply is made                                                                                                           |
| Thailand   | Export services are zero rated and are defined as “services provided in Thailand but totally used in a foreign country”                                                                                                 |
| Zambia     | Package tours by licensed tour operators which are sold to international tourists are zero rated  
             | All tourism services with the exception of food and beverages are zero rated in Livingstone                                                                                                                       |
| Tanzania   | Transportation of passengers is exempt and is defined as” Transportation of persons, by any means of conveyance including air charter but not including taxi cabs, rental cars, boats or boat charters”.  
             | Tourism services are exempt and are defined as “Tourist guiding, game driving, water safaris, animal or bird watching, park fees and tourist charter services”                                                   |
| Mauritius  | The transport of passengers by public service vehicles excluding contract buses for the transport of tourists and contract cars  
             | International transport of passengers  
             | The supply of services to a person who belongs in a country other than Mauritius and who is outside Mauritius at the time the services are performed.                                                            |
In markets with small and young tourism industries the promotion and sales of overseas tour packages is sometimes encouraged through the zero rating of the entire overseas tour package (including hotels, game lodges, activities, transportation, tours, etc), such as in Zambia and Rwanda. The intention is to grow these markets rapidly in the early stages of development by making the price of tour packages more competitive.

South Africa relative to other competitive and complimentary destinations in Africa is not in the same position with regard to the maturity and size of their market nor does it suffer from similar issues such as: poor infrastructure, lack of local production, high inflation and cost of capital, an unstable political economy and currency.

**Customs and Excise**

In a large majority of African countries, customs and excise levies contribute a significant proportion to costs and to the tax burden due to poor and limited local production. However, in South Africa strong local production and consistent progress on tariff reduction means that customs and excise rates are not so critical.

**Departure Tax**

South Africa adopts international best practice by including the departure charges in the ticket price. The amount levied as a gazetted departure tax is comparative and slightly lower than a number of countries in Africa, where departure taxes mainly range between $20 and $30. Malawi has recently increased their departure tax from $20 to $30.

<table>
<thead>
<tr>
<th>South Africa</th>
<th>Botswana</th>
<th>Mozambique</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Malawi</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td>R116 (+- $18)</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
<td>$30</td>
<td>$30</td>
<td>$20</td>
</tr>
</tbody>
</table>

**Other issues**

The current tax burden on the industry is not one of the major factors hampering the growth and development of the sector. Some of the major issues include safety, the high degree of seasonality, prohibitive and restrictive airline regulations, high cost of airline tickets, access to finance, lack of skilled labor, limited international marketing spend and lack of adequate tourism infrastructure.

In addition, the industry also suffers from excessive regulatory and compliance costs associated with additional levies, registrations and licenses which hamper the attraction of foreign direct investment and the growth of the sector, such as: labor regulations, black economic empowerment charters, employment legislation, environmental legislation, municipal licenses and levies (health and
safety, fire regulations, property taxes, vehicle licensing, electrical and building planning, etc) and tourism act registrations.

Increased international marketing can have significant benefits for the tourism industry and the general economy. An increase in international marketing spend can significantly increase demand and arrivals to the country. South Africa in comparison to other long-haul competitors like Australia and Thailand has a relatively young and unknown tourism industry, this coupled with a limited country marketing spend limits the reach of the international marketing efforts.

Box 10. Returns on international marketing spends

The British Tourist Authority estimates that every £1 of government spend on tourism marketing results in £25 spend on tourism. If the government were to receive 25 per cent of tourism spend in taxes, the government’s return on investment would be over 600 per cent.


Incentives

The purpose of the SMEDP grant is to provide much needed cash flow assistance in the first few years of the lifecycle of small and medium sized capital-intensive businesses. The SMEDP also creates a strong incentive for businesses to formalize, to plan, and to keep good financial records.

In practice, take-up of this grant is limited due to delays in processing times, laborious and complex application processes and discretionary approvals. The complex application and approval process means that consultants, who base their success fee on a percentage of revenue raised, drive the system. Delays in the processing of applications and payment of grants, means that the benefits do not arrive when they are most needed (in the first few years of operation).

From a tax policy perspective, broad based incentives which are non-discretionary, simplistic with low administration costs are far more effective in promoting development than discretionary subjective incentives. The SMEDP provides a good example of why, against these criteria, tax incentives are preferable to cash grants.34

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34 Cash grants have the advantage of being ‘on budget’ so the subsidy to the industry is transparent. The calculation and publication of ‘tax expenditures’ provides similar information for tax incentives.
Box 11. Market regulation in South Africa from 2002 - 2005

Over the past two years, the tourism industry in South Africa has seen the effect of market forces and a market correction. On the back of a large increase in international tourist arrivals in 2002, operators increased room rates and prices in 2003, in order to capitalize on this increase in demand. This effect was further compounded by the strengthening of the Rand (from around R11 /US$ in Sept 2002 to around R6/US$ Sept 2003). This along with industry price increases, caused prices in dollar terms to be 75% higher in 2004 than prices in 2001. Together with other issues internationally (the war in Iraq, the SARS virus and global economic uncertainty) resulted in a slowdown in tourism growth. Visitor arrivals increased only 1.2% in 2003. In order to curb the negative effect of the price increases on the market, a large number of operators froze prices in 2004 which contributed to a rebound in the market late in 2004 when an overall 2.7% increase in international arrivals was recorded. Based on our discussions with operators and based on the latest data available, this trend has continued into 2005 where operators are expecting significant growth in revenues and tourist numbers.

Analysis of the tax/incentive regime

The overall weighted average METR on capital in Tourism is just under 14%. This reflects the fact that as a rule Tourism is not eligible for special tax treatment in terms of lower statutory tax rates or accelerated capital expenditure allowances. Notable from Table 1 is the relatively low METR on buildings in the Tourism sector. This is not reflective of any special treatment per se, as expenditures on buildings in the tourist sector, including hotels, are written-off at the standard rate of 5% per annum over twenty years. Rather the low METR on buildings in this sector reflects the fact that expenditures on hotel refurbishments, so long as they do not involve an expansion of the existing hotel, are written-off over five years, at 20% per year.

Like the Manufacturing sector, we have undertaken an alternative set of calculations for the Tourism sector to illustrate the impact of the SMEDP, which in our interviews with the Private sector seemed to have been particularly important in this sector. For the Tourism sector, a 10% SMEDP grant generates the following METRs on capital:

<table>
<thead>
<tr>
<th></th>
<th>METR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Machinery and Equipment</td>
<td>-275.6%</td>
</tr>
<tr>
<td>Buildings</td>
<td>-28.2%</td>
</tr>
</tbody>
</table>

35 SA Tourism monthly international tourist arr4al statistics for May 2005 showed a year to date increase in international tourist arrivals of 10%, in comparison to the same period the previous year.
Land  5.3%
Inventories  32.4%
Total  -40.0%

**Recommendations**

- Hold workshops with key industry players and associations to tackle the complexities of the interpreting and applying VAT in the tourism sector, especially as it relates to transportation, tour packages and tour operators commission. The intention of the tax code needs to be clarified. The definitions of these laws may need to be expanded and improved in order to reduce manipulation and reduce uncertainty.

- Review the SMEDP to assess its impact and effectiveness. Given the transaction costs involved to both companies and government with the SMEDP, consider replacing it with an accelerated depreciation scheme or an initial investment allowance for small businesses.

- Any replacement of the SMEDP needs to take account its impact on the METR. Incentives in this sector, if any, should seek to reduce the effective tax rate of the marginal investment, rather than providing a subsidy across the enterprise as a whole.

- Promote the benefits of the small business taxation regime and encourage formalization through education sessions and workshops with the small and medium sized enterprises and representative associations, especially bed and breakfasts and tour operators.

- Explicitly exclude the transportation of tourists from the more general VAT exemption granted to public transportation.

- Investigate ways of increasing the countries international tourism marketing budget, possibly by formalizing the voluntary tourism levy.

**Financial Sector**

**Overview of Main Issues**

South Africa has a highly developed financial system, comparable in sophistication and size relative to GDP to those in Europe and North America. Financial sector regulation is also of a first world standard as is, to a high degree, the tax system as it applies to the financial sector. Indeed, the sophistication of the financial sector is one of the main challenges that both financial institutions and SARS face in trying to ensure that taxation of the sector remains equitable and does not reduce its international competitiveness.

This report has looked at two main sub-sectors in the financial services industry: banking and insurance. Banking, for the purposes of this analysis includes retail,
commercial, corporate, investment/merchant banking, trade finance and private equity/venture capital.

**Overview of the Tax and Incentive System in the Financial Services Sector**

As is common practice in many countries, the South Africa tax regime exempts financial services (interest, life insurance, medical schemes, provident, pension and retirement annuity funds) from VAT.

Otherwise, the sector is subject to standard tax treatment and receives no sector specific incentives. Instead, extremely complex, innovative and evolving products and services characterize the financial sector. The application of standard tax codes in such a situation creates many practical problems, which we now discuss on a product-by-product basis.

**Specific Tax Issues within the Financial Services Sector**

**Banking**

South Africa’s banking sector is highly sophisticated, and many of the complex derivative instruments popular in major financial markets in Europe, Asia and North America are common in South Africa. In the simplest terms, most derivatives involve the sale or swap of the cash flows accruing from an underlying asset such as a share or a loan without transferring the ownership of that asset. These cash flows can be pooled to create a marketable security, in a process called “securitization,” and then traded in the over the counter market or on an exchange such as the JSE’s interest rate market (Yield-X) or the JSE Financial Derivatives Market.

Information technology and increasing global integration of financial markets have led to an increasingly rapid cycle of innovation in the creation of derivatives, which outpaces the ability of SARS to determine the right approach to taxing such new instruments. This is not unique to South Africa. In many countries, it is common for tax legislation to lag commercial reality. Since cash flows from many derivatives are difficult to classify as either capital gains or interest, and because there exist timing issues in respect of recognition of revenues, tax authorities naturally view new derivatives with some suspicion as, potentially vehicles designed principally to avoid taxes. Banks complain that SARS does not generally issue advance rulings or opinions on how a derivative might be treated. Given the complexity of the issues involved in derivatives taxation, this reluctance is understandable, but bankers complain that the lack of clear guidance inhibits the development of new instruments that meet a genuine business need.
but which issuers and purchasers view as too risky, given the uncertainty as to the way these instruments will be taxed.

Tax authorities, by properly defining derivatives, can distinguish between those that serve legitimate trade purposes and those that are intended mainly for tax deferral or avoidance. Failure to do this, however, diminishes the competitiveness of a financial sector and makes it more vulnerable to arbitrage, which can have significant adverse tax effects for the Treasury.

As an article on Australian tax treatment of derivatives pointed out, “In view of the global nature of the financial market, international consensus and consistency is critical. In addition to international consistency, the design of any specific regime for the taxation treatment of financial arrangements should be as comprehensive as possible in order to effectively deal with arbitrage opportunities and the potential for tax induced market distortions.”

In other words, it is essential for tax authorities to establish clear rules and guidelines for treatment of both existing and new financial instruments that may have tax consequences. This is especially important in view of the increasing mobility of capital, which can allow corporations and financial institutions to book transactions in jurisdictions that provide more favorable tax treatment. To the extent that South Africa’s tax treatment of derivatives is less predictable or more stringent than that of other countries, companies that will tend to move this business to other jurisdictions. The net results could include a decline in tax revenues as fewer transactions are booked in South Africa, as well as a long-term decline in the competitiveness of South Africa’s financial sector.

SARS is not alone in this, but South Africa risks becoming less competitive in international financial markets as other major financial centers move towards consensus on common rules and principles. The lack of clear guidance in the tax code creates uncertainty and creates opportunities for arbitrage, which could, paradoxically, result in even greater tax losses for the Treasury.

The Income Tax Act does not refer to derivatives, stating “Where a taxpayer has ceded (assigned) a right to receive interest in exchange for dividends and thereby reduced his liability for tax, the Commissioner may determine the tax liability of the taxpayer and the other party as if the cession (assignment) had not taken place.”

In practical terms, South Africa’s Income Tax Act disallows any transactions that result in avoidance or postponement of tax liabilities if SARS deems these transactions to have been entered into for the primary purpose of postponing or avoiding taxes. In such cases, SARS may reinstate the liability that would otherwise have existed if the transaction had not been carried out. Section 103(1) effectively gives SARS complete discretion to determine the basis on which derivatives (or any other transactions) are taxed, if such transactions have any tax postponement of tax reduction effects. In practice, according to the Banking Association, SARS tends to adopt the attitude that such transactions are primarily for the purpose of tax avoidance and disallow any such benefits for tax purposes.

This provision of the tax code creates substantial uncertainty. To maintain competitiveness in global financial markets, the South African banking industry must be allowed to be as innovative as possible, which becomes difficult in an environment in which the tax treatment of any new instrument cannot be known in advance. The Banking Association cited several instances in which member institutions and their clients have shied away from introducing new instruments because the eventual tax treatment cannot be predicted. According to the Banking Association, however, pending legislation may authorize SARS to issue advance rulings, and SARS is in the process of constituting an advance rulings board, though the exact authority and composition of such a board is not yet known.

Other countries’ tax authorities have sought to address this problem, first by providing a definition of derivatives in the tax code and then by setting out rules that are comprehensive and flexible enough to allow financial institutions and their tax advisors to predict with some certainty how a given transaction is likely to be treated. Box 12 illustrates how the United Kingdom and Poland have at least partly addressed this issue by providing clear definitions of derivatives in their tax codes, together with any special exclusions.

Almost all tax codes recognize a difference between long-term and short-term investments, though many recognize that derivatives may have important purposes (mitigating risk) that are linked neither to one-way bets on short-term movements of interest or exchange rates nor to efforts to minimize or defer payment of tax liabilities. Basing definition and classification of transactions on the perceived intent of the investor can be risky unless they also comprise objective criteria, such as length of time an investment is held, which would be a reasonably reliable, though not perfect, guide to intent.

**Growth Capital (Private Equity/Venture Capital)**

Tax treatment of investments by limited partners (LPs) in growth capital vehicles, such as venture capital or private equity funds, is clear under the Income Tax Act. Private equity and VC funds normally have an investment horizon of five to seven
years, and a taxable event normally does not occur until a fund disposes of its interest in a portfolio company or when the fund is wound up (usually at the end of a defined 10-year life). The long-term nature and relative illiquidity of such investments mean that profits realized within a fund are treated as capital gains, subject to the 14.5% corporate capital gains tax (or 7.25% for individual investors).

Fund management companies often invest as limited partners in funds they manage as general partners. Though SARS has not issued a definitive ruling, in most cases it taxes the earnings from limited partnership investments by fund managers as ordinary income on the basis that their principal business is the buying and selling of investments. Fund managers that invest in their own funds are therefore subject to full corporate tax of 29% instead of the capital gains tax of 14.5%. Except for investments in listed shares, for which it has established a five-year threshold, SARS has refrained from issuing a definitive ruling as to what constitutes a capital gain and what counts as ordinary income, and instead judges transactions on a case by case basis, seeking to determine the “intent” of the investor in making a given investment. This leads to substantial ambiguity and risks reducing the taxable basis for many important forms of financing.

**VAT**

Interest income earned by financial institutions is VAT-exempt. Since interest comprises a high portion of income, especially for commercial and retail banks, only a small portion of the VAT paid by banks is recoverable. SARS applies a VAT recovery formula to most financial institutions, based on fee income divided by total income. For most banks, this works out to about ten per cent of total VAT paid as recoverable. This creates an incentive to convert as much of their income as possible from exempt forms (mainly net interest margin and trading profits) into fees, to increase their VAT recovery percentage, which in turn may be part of the explanation as to why commercial bank charges in South Africa are high. Distortions created by the exemption of some, but not all, financial services from VAT, is a problem common to most countries with VAT.
Box 12. Taxation of Derivatives in the United Kingdom and Poland

The United Kingdom specific tax legislation dealing with derivative contracts came into effect in October 2002. The new legislation started by defining a derivative contract as:
(a) an option, a future, a warrant or a contract for differences;
(b) an option to enter into a contract falling within paragraph (a), or
(c) a future relating to the sale of such a contract.” (UK Finance Bill, December 2001)

The law expands on this definition, stating that “Any reference to a contract for differences includes a reference to any other contract, the purpose or intended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in –
(a) the value or price of property, or
(b) an index or other factor designated in the contract”.

This definition is broad enough, unlike the corresponding sections of the South African Income Tax Act, to accommodate new instruments and to guarantee that, as long as they meet the essential characteristics of the definition, Revenue and Customs will accord them similar treatment to other instruments that meet the same definition. In many ways, this is better than any attempt to compile a comprehensive list of actual or potential derivative instruments that becomes obsolete the moment a new instrument is created that the law has yet to identify. The U.K. legislation does specifically exclude certain contracts from the above definition – mainly those for which the underlying assets (or “subject matter” as UK law calls it) are shares in a company, “unless such contract is held by a company for the purposes of a trade carried on by it.”

The legislation then goes on to define the “underlying subject matter” as: “(1) The property whose value or price is referred to in the contract, or (2) where an index or factor is designated in the contract, the matter by reference to which the index or factor is determined”.

This series of definitions serves to establish the basis by which a derivative will be valued, while the clause related to the trade requirement forms the basis for defining, for tax purposes, whether a transaction’s purpose is something other than tax avoidance or postponement. This provides essential clarity to the issuer, seller and buyer of derivatives as to the tax treatment they can expect.

Poland provides an alternative, and perhaps even clearer, definition under new legislation that came into effect in January 2001. “Property rights whose price depends directly or indirectly on the price of goods, foreign currency, Polish currency, exchange gold, exchange platinum or securities, as well as on amounts of interest rates or indices, and in particular options and term contracts”.

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38 Rudnicki, op.cit.
Insurance

Regressive Taxation of Individual Insurance Policies

The tax treatment of individual insurance policies disadvantages less wealthy taxpayers in favor of wealthier ones. Capital gains within a life insurance policy are taxed at 25% of an imputed average income tax rate of 30%, yielding an effective capital gains tax of 7.5%. Since poorer taxpayers may pay an ordinary personal income tax of 20% or even less, any capital gains they receive individually would be taxed at an effective rate of 5%. By investing in life insurance, poorer taxpayers pay a higher tax on capital gains than they would otherwise, At the same time, wealthier tax payers benefit, since their average income tax rate may be close to 40%, which would otherwise translate into an effective capital gains tax rate of 10%, but their capital gains in a life insurance policy are taxed at only 7.5%.

Double Taxation of Life Insurance Policies and Retirement Accounts: In South Africa, long-term life insurance is a popular savings vehicle, especially for retirement purposes. Life insurance companies must divide their policies into four different categories, each of which is taxed at a separate rate, as if it were a separate taxpayer. These categories are:

- Untaxed policy holder fund, exempt from income tax under Section 10 of the Income Tax Act, but subject to a special retirement funds tax of 18%;
- Individual policy holder fund, taxed at 29% on income;
- Company policy holder fund, taxed at 29% on income; and,
- Corporate fund, taxed at 29% of income.

The first category includes policyholders such as pension, provident and retirement annuity funds that are themselves exempt from tax. The corporate fund comprises those funds invested by the insurance company itself, which are not attributable to any policyholder.

These funds are also subject to capital gains tax at a rate of 14.5% for corporate policy holders (one-half of the capital gain at the corporate income tax of 29%) and 7.5% for individual policy holders (25% of the capital gain at an assumed average personal income tax rate of 30%),

Life insurance policy distributions are also taxed as ordinary income, as are annuities received from retirement accounts, at the rate that would apply to the individual policy holder at the time of distribution.

The double taxation of both life insurance policies and retirement accounts is at odds with normal practice in most countries, where they are taxed only at the time
of distribution (i.e., on retirement). Taxation of gains within a policy or fund is actually more onerous than the tax on distributions, since it reduces the compounding of reinvested interest, dividends and capital gains, which is one of the most attractive features of such accounts.

Short-term insurers (i.e., property and casualty underwriters) are taxed at the normal corporate tax rate of 29% on premium and investment income (excluding dividends), and they are allowed to claim deductions for operating expenses, reinsurance premiums and paid-out claims. Additionally, they are allowed to claim a temporary deduction of up to 40% of premium income for unexpired risks (expected future claims in the subsequent tax period). These allowances are added back and recalculated in the following tax year.

The Tax Regime in Practice

Taxation of Private Equity and Venture Capital

When South Africa introduced the capital gains tax in 2001, the South African Venture Capital Association (SAVCA) made several representations to SARS requesting that they issue a clear ruling on the capital gains/ordinary income issue in respect of investments by fund management companies as limited partners in funds they themselves manage. The concern expressed by SAVCA and by fund management companies is that similar classes of investments, such as unit trusts, receive more favorable tax treatment. Income in unit trusts is treated as a pass-through and not taxed. This disparity in tax treatment renders unit trusts more attractive to investors, and SAVCA is concerned that unless SARS issues a clear ruling on future treatment of these investments and unless it provides greater equality in tax treatment of investment partnerships, private equity and venture capital funds will see their investors move into different equity classes.

Many countries provide a clear definition in their tax codes of long-term investments, taxable at a lower rate, and short-term investments, the gains from which are taxed as ordinary income. In the United States and India, the tax authorities deem all investments held for more than one year long-term investments. In Australia and several other countries, the cut-off is at three years. South Africa allows for gains from assets held five years or more to be treated as capital gains, but this provision applies only to listed shares.
Box 13. Principles for Tax Treatment of Private Equity and Venture Capital

A 2003 study of venture capital and Private equity in Europe, conducted by the European Private Equity and Venture Capital Association (EVCA), stated that “the absence of an efficient domestic fund structure can result in a need to use foreign structures, incurring substantial transaction costs and resulting in a sub-optimal solution.” In other words, if domestic companies cannot obtain equity capital from domestic funds they must turn to foreign sources. Because foreign funds will have limited domestic knowledge and limited capacity to identify and evaluate deals, overall investment flows are likely to be lower, many companies will find it more difficult to obtain the capital they need, and commissions and other transaction costs are likely to be higher. The EVCA went on to propose guidelines for optimizing investment fund structures so as to enable economies to reap the greatest benefits from an increase in private equity and venture capital activity. The guidelines highlighted:

“Tax transparency for domestic investors: An investment into a company through a fund should be treated, for tax purposes, as if it was an investment in the underlying companies. Tax transparency for the fund would avoid potential double taxation for domestic investors.

“Ability of international investors to avoid a permanent establishment: The investment of an international investor in a foreign country should not create a permanent establishment. Otherwise, the investor would be liable for national taxes, which could potentially lead to double taxation.

“Ability to incorporate a tax-efficient and performance-related incentive or investment in the form of capital for fund managers of venture capital and Private equity funds: Carried interest schemes can provide Private equity and venture capital funds with valuable incentives with which they can attract highly qualified fund managers…Carried interest schemes can prove to be an important mechanism for aligning the interests of investors and venture capitalists in a relationship that will last, on average, for 10 years.

“Ability to avoid paying Value Added Tax (VAT) on management charges and carried interest: The payment of VAT can become an irrevocable cost for the fund when VAT cannot be recovered, and therefore, this situation should be avoided.”

“Ability to avoid undue restrictions on the type of investments carried out by the fund. This is essential for optimal allocation of the fund.”

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For other assets, South Africa’s tax authorities apply a test of investor intent, though the length of time an asset is held can also be a factor. Since the tax code does not provide a clear definition of intent, investors are subject to considerable uncertainty. Although taxation is rarely the only or even the most important consideration in an investment decision, it is certainly a factor that any responsible investor or investment advisor would take into account. If certain classes of investments, such as private equity, are subject to substantial uncertainty as to the eventual tax treatment of investment proceeds, investors will naturally tend to invest in other asset classes that are not subject to the same ambiguity. The result can be a loss of investment in critical areas and a loss of efficiency of capital markets.

Private equity is, arguably, more important for the growth of entrepreneurial activity, than public equity. Tax treatment of private equity and venture capital can have significant effects on the importance the industry plays in a country’s economic growth and especially in the development of new, high-growth, entrepreneurial companies. European venture capital firms, for example, are often criticized for taking a more “hands-off” stance towards portfolio companies than their U.S. counterparts, which often get directly involved in management. This historical difference –eroded in many countries – has almost nothing to do with culture or management style and everything to do with the tax code.

South Africa’s current system of taxing private equity and venture capital may have the perverse effect of steering investment from earlier stage entrepreneurial activity to larger companies whose contributions to growth in income, employment and opportunity may be proportionally smaller.

Private equity funds in South Africa are also subject to STC, except on payments to tax-exempt entities like pension funds. This places South African venture capital and private equity at a competitive disadvantage with respect to other countries. Many countries impose a withholding tax on fund distributions to non-resident investors, but in most cases this is recoverable by the investor in his home country through double-taxation treaties, unlike STC, which is not recoverable (except where there is a double taxation treaty in force, when it is creditable).

VAT is another important issue for private equity. Most, but not all, countries exempt management fees and carried interest from VAT charges. This is the case in South Africa, except for management fees in respect of domestic investors, for which VAT is chargeable on management fees.

In South Africa, most fees and commissions on financial services are subject to VAT. For private equity fund managers, management fees received from domestic investors are subject to VAT, while for offshore investors they are zero-
rated. This practice is, increasingly, at odds with practices in the rest of the world, and can have the effect of discriminating against domestic investment in favor of foreign investment. As South Africa seeks to increase black economic empowerment by increasing the share of the economy owned by members of historically disadvantaged groups, the current practice by which domestic investors are subject to taxes from which foreign investors are exempted might merits review.


Countries vary widely in their tax treatment of private equity, and this treatment correlates to a large degree to the size and dynamism of a country’s private equity industry and its contribution to management innovation, jobs and income growth. Developing countries, many of which expect new information and communications technology (ICT) and other high-tech industries such as biotechnology, to be an important driver of future economic growth, should bear in mind the important contributions private equity and venture capital have made to development of those industries in countries such as the United States, the U.K., Ireland, Israel and India.

One of the key issues in taxation of private equity, as for other equity classes, is transparency, which in this context means that earnings from a fund, instead of being taxed at the source (taxation of the fund) are passed through to the investors in the fund, which then pay tax on their earnings. Closely related to this question is that of whether private equity fund earnings are taxed as ordinary income or capital gains, whether tax is levied at source (the fund itself pays taxes) or on the recipient.

The other main issue in private equity taxation is the treatment of the carried interest of fund managers and of the income from any investment by fund general partners or managers in the fund. Some countries, including South Africa and Germany, have been hesitant to introduce the principal of transparency for private equity as they have been to accord favorable tax treatment to carried interest or proceeds from investment by fund managers. Countries with especially vibrant private equity and venture capital industries tend to take a more liberal approach.

In Ireland, a fastest-growing economy, the income and gains from approved Qualifying Investment Funds are exempt from tax. No withholding taxes are imposed on payments to non-resident investors, who are responsible for tax to the authorities in their own domicile. Irish investors are subject to withholding tax on payouts from the fund at the standard corporate income tax rate of 12.5%. Carried interest and management fees paid to resident Irish managers are taxed at the ordinary corporate income tax rate of 12.5%. In Ireland, unlike almost every other country, the capital gains tax rate, at 20%, is higher than the corporate income tax rate. Corporate investors in private equity therefore have a strong interest in having their earnings taxed as ordinary income instead of capital gains. For individuals, for whom the top income tax rate is 42%, the converse is true.

In Australia, private equity partnerships and funds are transparent, with all income treated as a flow-through to investors. Carried interest is taxed as a capital gain.
In the United States, most private equity and venture capital funds are structured as Limited Partnerships (LPs) or Limited Liability Corporations (LLCs). Both of these structures are flow-through entities that are not themselves subject to tax. U.S. tax law treats gains on any investment held more than 365 days as a capital gain, taxable at a maximum 15% for individuals. Corporations, however, are taxed at 35% on both ordinary income and taxable gains. Carried interest is taxed as a capital gain.

Israel has the second-largest venture capital/private equity industry in the world, after the USA. Most funds established themselves as Limited Partnerships, in which the fund itself is not a legal entity but instead, the aggregate of the interests of the limited partners, most of which are also LPs. Funds, therefore, and most of the investors in funds, are pass-through entities. Proceeds are treated as capital gains, which are taxed at 25% (often less some exemption for the effect of inflation on the capital gain). The normal corporate income tax rate is 34% (to drop progressively to 30% by 2007) and ordinary personal income is taxed at a top rate of 49%.

India has experienced explosive growth in its technology sector, especially in ICT and related services such as call centers and software development. Venture capital has contributed to this development. Venture capital and private equity funds are exempt from taxes, while fund distributions are generally treated as capital gains and taxed at the 10% capital gains tax as opposed to the corporate income tax rate of 35.7% (or 48% for non-resident companies) or the top personal income tax rate of 40%.

**Insurance**

Insurance companies invest their premium income and so are subject to many of the same taxation issues facing other financial investors in South Africa. Long-term (life) insurance and short-term (property and casualty and medical) insurance are treated differently, since life insurance itself is a vehicle for personal investment and savings. Nevertheless, the main issues having to do with tax treatment of different kinds of income are nearly identical. Most of these issues stem from inconsistencies in the way SARS views and defines investments and their purpose.
Box 15. Intent versus timing in taxation of revenues

In one notable example, one of South Africa’s largest insurers invested in a health insurance company that had invested some of its premium income in a portfolio of equities. The purpose would seem to have been clear: to match the duration and expected return on its investments with the timing and size of future claims. The equities portfolio was managed on a long-term basis, characterized by relatively few trades and long holding periods for individual securities. A downturn in business conditions forced the health insurer to liquidate its portfolio, the proceeds of which SARS treated as income from a speculative investment subject to normal corporate income tax. This is an example where, if SARS had consistently followed the “intent” principle based on the nature of the investor’s business and the purpose of the investment, it would have designated this a long term capital investment, even if exceptional circumstances forced a premature sale of the assets. SARS could, alternatively, apply something like the U.S. rule that defines investments held for up to one year as speculative and anything over one year as capital investment. The U.S. system also has its faults, with some investors no doubt caught in a position similar to that of the South African health insurer, with long-term investments that suddenly become short-term investments for unforeseen reasons. Nevertheless, the existence in the U.S. of clear rules means at least that the tax consequences of the decision to sell off the equity portfolio would have been known in advance.

It is important that any system should have clear rules, whether they are based on intent or on holding period. The main virtue of a classification based on holding period is that it removes any ambiguity or subjectivity from the system, even if in some ways an intent-based approach is theoretically more appropriate. It can be hard to craft rules that will appropriately classify all existing investments, much less new ones that have not yet been made. Either way, insurance companies and other investors will benefit from clear rules that enable them to undertake efficient tax and investment planning. This in turn can benefit the revenue authorities by encouraging investment and increasing future tax revenues.

The regressive feature of capital gains taxation in long-term insurance funds where capital gains are taxed on an assumed 30% average personal income tax rate is unfair.

**Retirement Funds**

South Africa is one of the few countries in the world that tax retirement funds (pension funds, annuity funds and provident funds). These funds were tax exempt until the Katz Commission recommended that they be taxed, starting in 1996 with interim measures that imposed a tax on gross interest and net rental income.
derived by retirement funds, and on the untaxed policy-holder funds of long-term insurers (the system described immediately above dates to this era). The tax, initially 17%, was raised to 25% in 1998, though it was subsequently reduced to 18%, where it stands today.\footnote{This was subsequently lowered to 9% in the 2006 Budget.} Capital gains in retirement funds are not taxed. When rental expenses and allowances exceed rental income, the loss may not be set off against gross interest, but may be carried forward and applied to rental income in the next tax period.

South Africa does exempt retirement fund contributions up to a maximum of R1, 750 per year or 7.5% of taxable remuneration, whichever is greater. On retirement, monthly pension payments are taxable as ordinary income.

In the European Union, retirement fund contributions and investment income and capital gains are tax exempt, while the benefits (distributions) are taxed. The same is true in the United States, although there are caps on tax-exempt contributions in dollar amounts and as a percentage of taxable earnings (i.e., an employee cannot shelter his entire salary by investing it in a retirement fund such as an IRA or a 401(k)). In the EU, only Denmark, Italy and Sweden tax income and capital gains from the funds, and the European Commission, since the adoption of the Pension Directive in May 2003, is trying to eliminate these differences.

In most countries voluntary retirement schemes are intended to encourage saving by individuals. Higher savings rates – up to a point – have important macroeconomic benefits, while Private retirement savings reduce the future fiscal burden on the state. Voluntary retirement schemes in general contain powerful incentives to invest. These include:

The ability to shelter current income from tax by investing pre-tax earnings (tax exemption of fund contributions);
Higher investment returns from tax exemption of earnings within retirement funds and higher reinvestment rates and compounding as a result;
The expectation that income needs will be lower in retirement, so retirement fund draw-downs will be lower than previous salary and thus subjected to a lower tax rate.

It is possible to question these assumptions, especially the last, since many retirees may have enough income to be taxed at the same rate as when they were working. But the tax-free accumulation of dividend, interest and capital gains income within a retirement fund is the most powerful of these incentives and
makes the greatest contribution to the future financial independence of retirees. Taxing this income is also inherently unfair, since it constitutes double taxation.

**METR Analysis of the Financial Services Sector**

With an overall weighted average METR on capital of just under 30%, the financial sector bears one of the highest marginal tax burdens on capital of any of the sectors studied. This is the case for two reasons. The first is because the sector is not the beneficiary of any special incentives in terms of the statutory CIT rate or allowances for its capital expenditures. The second has to do with VAT. With some exceptions, most of the activities of banking institutions, an important part of the financial sector, are exempt from VAT. This means that banks do not charge VAT nor are they able to claim input credits for the VAT paid on much of their inputs. Thus, like non-registered SBCs, banks can bear a heavy effective ‘sales tax’ type burden on their inputs. Information from SARS suggests that about 25% of the turnover of all financial institutions is tax exempt. The resulting indirect tax on bank inputs is what generates the high METR on capital equipment in the financial sector illustrated in Table 1.

One should note however, that while the METR calculations suggest a high capital tax burden on the financial sector, there are many subtleties of the tax system as it relates to this sector that cannot be captured by the METR methodology. In particular, structured financing and the ability of financial institutions to easily move money, and book loans, between jurisdictions is a well known problem in this sector.

**Recommendations**

Taxation of the financial sector is complex in all countries. Different countries at different stages of development have different needs, so it is unrealistic to seek to impose a uniform set of international best practices on South Africa. Many of the most contentious issues in taxation of the financial sector are based on a lack of clarity as to the rules and how they are applied.

- In order for South Africa’s financial sector to become a source of national competitive advantage, **investors and financial institutions need greater clarity as to the rules that will apply to given investments or investment vehicles, and greater transparency in how those rules are made and applied.**
- The Treasury and SARS should develop and set out clearer definitions and eligibility criteria for treatment of investment proceeds as capital gains or as ordinary income, as interest or as dividends. Those rules and definitions should be precise enough to provide sufficient advance guidance to investors as to the probable tax treatment of their investments,
while also being flexible enough to accommodate new instruments without requiring either ad hoc judgments or new legislation.

- SARS should establish clear definitions of derivatives and clearer rules on how they are taxed.
- South Africa would make its venture capital/private equity industry far more competitive and closer to international best practice, and would increase the industry’s contribution to investment, innovation, and employment and income growth if it were to:
  - Allow funds to operate as tax-exempt pass-through entities (i.e., as limited partnerships or similar structures). As shown in Box 12, South Africa is one of a very few countries that do not allow this, though the Netherlands, Finland, Norway, Sweden and Germany allow transparency for domestic, but not foreign, fund investors. This restriction limits the willingness of foreigners (or, in the case of South Africa, both domestic and foreign investors) to invest in private equity;
  - Treat all private equity fund income as capital gains. Even if funds themselves are structured as tax-exempt pass-through structures, the eventual tax treatment of distributions from private equity funds is important in jurisdictions in which capital gains are subjected to lower tax rates than ordinary income.
  - Allow profits from investments by general partners in a fund to be treated as capital gains;
  - Treat carried interest earned by fund managers as capital gains instead of ordinary income.
  - Subject fund management fees paid by offshore and domestic investors to equal treatment.
  - **South Africa should strive to bring its treatment of insurance companies and retirement funds into closer conformity with international best practices in ways that will increase fairness and stimulate private savings and investment.** It can do so by exempting interest, dividend, rental and capital gain income in retirement funds and insurance company investment funds from taxes, as is common practice in most countries, which tax such income on distribution to the investor or retiree. Making this income tax exempt at the level of retirement funds and insurance company investment funds will also eliminate the problem of taxing lower-income investors’ capital gains in insurance funds at a higher rate than they would otherwise pay, while providing a tax break for wealthier investors.
**Small Business Sector**

The Small Business Corporations (SBCs) corporate income tax provisions in SA are restricted to companies or close corporations with gross income not exceeding R6 million. There are two types of incentives available to SBCs. The first is a graduated tax rate, with 0% applied up to taxable income of R35,000, 10% on taxable income in excess of R35,000 and up to 250,000, and the full 29% rate on taxable income in excess of R250,000. Note that SBCs must pay the STC on dividend distributions, regardless of their taxable income.

The second type of incentive for SBCs is accelerated depreciation allowances. SBCs involved in manufacturing are able to write-off machinery and equipment immediately, at 100%, rather than the typical write-off rate of 20% per annum (5 years straight line). Other, non-manufacturing, SBCs can write equipment off at a 50:30:20 percent rate over three years.

Another issue that arises in connection with SBCs is registration for the VAT. SBCs with turnover less than R20,000 cannot register for the VAT, while registration is optional for corporations with turnover in excess of R20,000 but less than R300,000, and compulsory for companies with turnover in excess of R300,000. The registration thresholds are designed to lower VAT compliance costs for small business owners. There is no doubt that the thresholds accomplish this objective, as small business owners often find VAT compliance complicated and costly.

A difficulty that arises from this, however, is that SBCs which are not able to, or chose not to, register for VAT end up paying VAT on their business inputs, and in particular on their capital. With a VAT rate of 14%, as will be seen below this can have a significant impact on the METR on capital in these circumstances.
Box 16. Taxation of small businesses: International best practice

International best practice suggests that any special tax regime for small enterprises should offer reduced compliance costs and a reduction in the actual tax burden. This reduction in the actual tax burden is intended both to compensate, to some extent, for the particular difficulties that this sector faces in accessing capital and to act as an inducement to enter the “formal sector”.

Experience in transition countries has shown that simplified tax systems generally not only reduce compliance costs bookkeeping, and reporting standards but also considerably lower the actual small business tax burden, revenue yields mostly are minor and represent a negligible share of total tax collection. Clearly revenue collection is not the key objective of simplified systems in transition countries. They have more been designed to encourage businesses to register with the tax authorities and facilitate the operation of small businesses in the formal economy and to support the establishment of links between the small business community and government agencies. However, a too generous system risks to create a situation where collection and compliance costs exceed the amount of tax collected. In addition, the lack of coordination of the tax burden under a presumptive tax with the tax burden under the standard tax system works as a disincentive to declare business growth and migrate from the presumptive to the standard tax system.

Sources: FIAS, and adapted from Engleschalk (2004) “Creating a Favorable Tax Environment for Small Business Development in Transition Countries”, World Bank manuscript

In Table 7 METRs on capital are illustrated for SBCs operating in the Manufacturing, Agriculture and Tourism sectors according to their CIT tax bracket (0%, 10% and 29%). As discussed above, this table imposes a small open capital market assumption, which may not be applicable to the small business sector. However, it is useful to consider these calculations for comparative purposes with other sectors in the economy. Alternative calculations in a closed capital market context are discussed below. Panel A presumes that the businesses are registered for the VAT and therefore receive the input tax credit for VAT paid on capital purchases, while Panel B presumes that the businesses are not VAT registered, and therefore pay VAT on their business inputs (it is assumed here that this applies just to investment in machinery and equipment).

The table illustrates that there is a wide variation in METRs on capital in the small business sector, depending upon the VAT status of the firms and their CIT rate. Consider panel A, which assumes the businesses are registered for the VAT. For businesses in the lowest tax bracket (with earnings less than R35,000) which are VAT registered (with turnover greater that R20,000) – the METR on capital is zero, as these corporations pay no corporate income tax and face no implicit taxes on their capital due to the input crediting features of the VAT. For SBCs in the higher tax brackets, the METRs are positive, as some tax is paid on capital due to the corporate income tax, but quite low relative to the large corporations in Table
1. Even SBCs in the 29% bracket face lower METRs because of the fast write-off of equipment.

Panel A therefore suggests that the special provisions for SBCs implemented in SA do what they are supposed to do – they lower the METR on capital in this sector, and therefore encourage investment relative to large corporations. This is good news from small businesses in South Africa.

However, two further considerations need to be included in the analysis.

First, SBCs with turnover of less than R20,000 cannot register for the VAT; and many SBCs who could voluntarily register for VAT chose not to do so – because of the compliance costs, lack of education etc. In these circumstances the SBC cannot claim the input tax credit. Panel B provides calculations for SBCs that are not VAT registered. Non-VAT registration has a substantial impact on the METRs. Even businesses that pay no corporate income tax (the first three columns of panel B), face very high effective tax rates on capital because of the VAT imposed on equipment. Indeed, non-VAT registered SBCs face among the highest METRs of any sector. This highlights the importance of bringing SBCs into the tax net, an issue that we return to below.

Second, as discussed above, SBCs differ from large corporations in their ability to access international financial markets. For large corporations, South African personal income taxes levied on the return to capital in the form of taxes on interest, dividends and capital gains have no impact on domestic investment because the required after-corporate-tax rate of return on investments is fixed by international financial markets. Small businesses, on the other hand, cannot access these markets. These businesses effectively face a segmented local capital market that can be thought of as closed for analytical purposes. This means that personal income taxes paid by South African investors in SBCs may well have a sizable effect on domestic investment by lowering the after-all-taxes (corporate and personal) rate of return.
Box 17. An argument for small enterprises “opting-in” to a VAT regime, despite compliance costs

There are important circumstances in which it is commercially advantageous to be fully liable for VAT. This includes firms selling zero-rated items and, potentially even more important, those selling to other firms that would wish to register for VAT in order to effectively reclaim tax paid on their own inputs. For these reasons, it is normal practice to allow firms to register for VAT voluntarily. The right is subject, typically, to provisions guarding against temporary or fraudulent registration simply to obtain refunds: deregistration is commonly restricted, for instance. Indeed there is a sense in which a reduction in the threshold is self-enforcing: the more firms that are subject to VAT the greater the likelihood that a trader will find themselves selling to registered traders and so will find it advantageous to register too.

Even when it is commercially advantageous to be below the threshold, however, the extent of that advantage should not be overstated. Small traders will be unable to recover VAT on their inputs: it is only their own value added, not the full value of their sales, which escapes taxation. Nevertheless, there clearly is potentially some cause for concern. In particular, firms characterized by a high ratio of value added to sales and selling to unregistered purchasers—small traders providing services directly to final consumers being the key group here—are likely to find it worthwhile to be exempt from VAT. Thus equity considerations would tend to point toward higher thresholds than would otherwise be the case.


Table 8 provides METR calculations for SBCs under these assumptions. Unlike Table 7, which incorporate only corporate taxes levied capital income, as discussed above these calculations incorporate both corporate and personal income taxes. The calculations show that the METR on capital rises substantially when the capital market is closed. This is because of the imposition of taxes on capital at the personal level. Also, in the open capital market scenario the secondary tax on corporations (STC) imposed on dividend distributions has a negligible impact on the METR. In the closed economy scenario the impact is substantial – for small businesses the STC adds about five percentage points to the METR on capital.

This suggests that if one considers the impact of the entire tax system – corporate and personal taxes – on small businesses in a closed capital market context, the METR on “entrepreneurial” investment undertaken by small businesses, is higher than an initial ‘simple average affective tax rate’ analysis might suggest.
Analysis of the tax system against international comparators

METR calculations for selected comparator countries are provided in Annex F. Calculations are undertaken for two sectors – the manufacturing sector and the broad service sector, the latter being an amalgam of various non-manufacturing sectors. The data suggests that South Africa is relatively competitive within this group of countries. In particular, in terms of the developed OECD economies in the table, such as Canada, Australia, and New Zealand, the METR on capital in South Africa is relatively low. The aggregate METR on capital in South Africa is also lower than India, an emerging economy that has exhibited relatively high growth rates over the past several years.

The story changes somewhat with respect to selected less developed African countries. Here we see that the story is mixed. The South African aggregate METR is higher than Tanzania and Uganda, but is lower than Kenya and Zambia. The lower METRs in Tanzania and Uganda are due to targeted incentives. The METR calculations in Kenya and Zambia are skewed because of relatively high levels of inflation in these two countries, particularly in Zambia. Inflation interacts with the tax system in complicated ways. For example, the high rate of inflation in Zambia results in a heavy tax subsidy for land, because of the deductibility of nominal interest charges, and a very high tax burden on inventories because of the taxation of inflationary increases in the value of inventories arising from FIFO inventory accounting.

It is typically believed that developed countries can sustain higher effective tax rates on capital than less developed countries, simply because developed economies have other characteristics that are attractive to capital investment. Less developed economies, on the other hand, need to impose low taxes on capital in order to overcome the lack of these other factors and attract capital. In some ways South Africa shares characteristics of both developed and developing economies, and so its status as a “in between” country in terms of METRs seems sensible. However, one must be cautious in this assessment.

The developed economies included in Annex F – Canada, Australia New Zealand – have relatively high METRs on capital compared to other developed economies. For example, countries such Ireland, Sweden, the Netherlands, etc., have METRs on capital substantially lower than these African countries.41 There are also

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41 See Chen and Mintz (2005). In general it is inappropriate to compare METR calculations across different studies, as different studies follow different methodologies and make different assumptions about key parameter values and are therefore not comparable. However, importantly, we have adopted the same methodology and underlying assumptions as the C.D. Howe Institute, and therefore our calculations are directly comparable.
indications METRs on capital in some OECD countries are poised to drop. This suggests that South Africa cannot afford to be complacent in terms of its tax policy as it relates to capital investment, particularly in terms of promoting growth.

**Recommendations**

Based on our METR analysis, in our view the tax system in SA is fundamentally sound from a structural point of view. In particular, in terms of METRs on capital the tax regime is relatively competitive internationally and not completely out of line with other African countries given its state of economic development. The sector analyses above have identified sector specific changes to the tax regime which should be given due consideration.

The METR model is flexible enough to allow modeling of various scenarios to assess their impact on the METR faced by business. Several iterations of this model produced interesting results which lead to some economy wide conclusions on how to lower the METR faced by firms without major adjustments to tax instruments or rates. These recommendations are:

**Review Tax Depreciation System**

While we did not engage in an exhaustive examination of South Africa’s tax depreciation system, our general impression is that government should undertake a comprehensive restructuring of the system.

When undertaking this examination the following guidelines should be kept in mind: (1) under most circumstances, classifying assets into, say, four or five categories should be sufficient, e.g., grouping long-lived assets such as buildings at one end and fast-depreciating assets such as commercial vehicles and computers at the other end, with one or two categories of machinery and equipment in between; (2) only one depreciation rate should be attached to each asset category; (3) depreciation rates should generally be set higher than the actual physical lives of the underlying assets to compensate for the lack of an inflation-compensating mechanism; and (4) on administrative and compliance grounds, the declining-balance method is preferred to the straight-line method. The declining-balance method allows the pooling of all assets in the same asset category and automatically accounts for capital gains and losses from asset disposals, thus substantially simplifying bookkeeping requirements.

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42 Charles McClure (2005, C.D. Howe Institute Benefactors Lecture), for example, speculates that effective tax rates on capital in the U.S. are likely to fall as the result of a tax reform discussion currently taking place in the United States.
South Africa employs the straight-line approach to tax depreciation, sometimes offering “accelerated” deductions for some sectors. However, because South Africa (as with most tax regimes) does not allow inflation indexing, some of these deductions may not be as “accelerated” as one might think. Moreover, for reasons discussed above, a declining-balance approach would be preferred on both administrative and compliance grounds. The latter is particularly important for small business corporations, as there would be no need to keep track of each individual piece of capital.

**Move to LIFO Inventory Accounting**

As discussed above, the use of FIFO inventory accounting for tax purposes results in very high METRs on inventory capital because of the taxation of inflationary gains. Moreover, inventory capital accounts for a large share of capital in some sectors – in particular manufacturing. The impact is significant, even for quite modest levels of inflation. For example, instituting LIFO accounting for the manufacturing sector in South Africa, at an inflation rate of only four percent, would lower the METR on inventories for large corporations from 32.4% to only 5.3%, reducing the aggregate METR in the manufacturing sector from 21.3% to 16.3%. This is a substantial reduction. Thus, the move to LIFO accounting would do much to lower the overall METR on capital in South Africa.

**Review Incentive Programs**

While the tax system in South Africa does not contain an over-abundance of targeted incentive schemes (such as tax holidays, targeted investment allowances and investment tax credits, etc.), we did analyze one such program – the Small and Medium Enterprise Development Program (SMEDP), targeted at, well, small and medium sized businesses. As we showed above, under some circumstances small businesses in South Africa can face very high METRs on capital, particularly if they are not VAT registered. However, and SMEDP program is not a very good way of dealing with this. As will be discussed below, a better approach is to take steps to bring small business corporation into the tax net. Moreover, as also shown above, the SMEDP program can result in grotesquely negative METRs on capital. In light of this, our recommendation would be that the SMEDP program not be renewed in its current form.

Similarly, the Strategic Investment Program targets support to very large firms. However, the incentive is so large that it provides a significant subsidy to the firm as a whole, rather than just the marginal project.
Bring Small Business Corporations into the Tax Net

As shown above, for SBCs “in the tax net” – paying corporate income taxes and VAT registered – METRs on capital are relatively low. This is the policy intent of some of the measures in the income tax geared towards SBCs. However, for SBCs “outside of the tax net” METRs can be quite high, particularly due to non-VAT registration. Every effort should be made to bring SBCs into the tax net. While we do not have any specific recommendations in this regard, consideration should be given to implementing a simplified VAT approach for small businesses.

Some countries do this via a presumptive turnover tax on revenues. This is not an approach we recommend, for several reasons. One is that such a tax is presumptive, and therefore can lead to cash flow problems. Another is that as a turnover tax there is no accounting for input costs, which can increase the METR on capital even more than it currently is for non-registered companies. A better approach, in our view, would be to consider a so-called “quick” methods for calculating VAT in several countries. There are two ways of doing this. The most widely followed approach – used, for example, in Canada – works as follows. Rather than tracking the tax collected on every sale and the tax paid on every purchase under the regular VAT system, under the quick method, a business’s net tax remittance is calculated by simply multiplying the company’s total VAT on sales by a prescribed quick method remittance rate. The prescribed remittance rate takes into account, on average, the tax that eligible businesses pay for inventory and taxable operating expenses, and can vary by industry. The quick method remittance rates can be set even higher to provide an incentive for small businesses to register. The only information needed under the “quick” method is gross revenues, or turnover, and there is no need to track sales via invoices.

An alternative approach, which to our knowledge has not used elsewhere, is to impose a Business Transfer Tax (BTT) at the small business level. In this case, the tax remittance is calculated by subtracting expenditures on all inputs (including capital) from total revenue. In this case the business needs to keep track of cash flows rather than just revenue, and so entails more compliance and administrative costs than the simple quick method discussed above.

In terms of the corporate income tax, moving to a LIFO system for inventories and adopting a declining-balance approach to tax depreciation would also make it easier for SBCs to comply with the tax system.

Reduction in the CIT Rate

At 29% the corporate income tax rate in South Africa is not out of line with other countries, and indeed is on the low end. Some developed countries, most notably Ireland, have reduced CIT rates significantly. A related issue involves the
Secondary Tax on Companies (STC). This is a tax on dividend distributions, currently imposed at 12.5%.

In the course of our consultations in South Africa, we periodically heard arguments for eliminating the STC. In our view this would not be advisable without replacing it with something else, presumably a tax on dividends imposed at the personal level coupled with a withholding tax on dividend payments made to non-resident shareholders. As it currently stands, the STC results in a tax on corporate earnings distributed as dividends of about 36.9%, which is slightly lower than the top personal tax rate in South Africa of 40%. Thus, dividends are (almost) perfectly integrated under the current system. The tax rate is 10% on realized capital gains, resulting in a tax on corporate earnings realized as a capital gain of 35.3%. However, note that capital gains are taxed on accruals only, so that the accrual equivalent capital gains rate, which accounts for the deferral of capital gains taxes until an asset is sold, is considerably lower than this. This suggests that there is room for a reduction in the tax rate on dividends, whether it be imposed at the personal level or at the corporate level via a dividend distribution tax. This would be particularly beneficial to small businesses (who are in the tax net), for the reasons discussed above.

Conclusions

The results of the qualitative and quantitative study of five sectors in South Africa suggest that overall, sector effective tax burden, both rates and application of the tax regime, is quite low on average. Comparison of these sectors in neighboring SADC countries and ‘peer economies’ globally, reveals that South African sectors are broadly competitive in terms of the tax on capital. Although the general assessment is that the tax/incentive system is appropriately pro-growth, there is room for second order adjustments, as detailed in the sector reviews above.

The METR exercise shows that only capital in the financial services sector is taxed at a relatively high rate, in the neighborhood of 20-30 percent, primarily because the sector is exempt from VAT (and so VAT is paid on capital inputs but can only be reclaimed on a portion of revenue).

The existence of METR differentials, however, suggests that the tax system could contribute to the composition of investment, with the primary distortions being a strong tax bias against investment in inventories and a strong tax bias favoring debt finance. The former problem could be addressed by encouraging firms to switch to the LIFO accounting system, a change that, if extended to financial

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43 .29+ (1-.29)*(.125/1.125) = .3688.
44 Where the owner of the equity is an individual (.29+ (1-.29)*(.10/1.10) = .353) rather than a corporation.
statements, would in most cases also result in more accurate measurement of income for financial accounting purposes. The latter problem is a standard one under the income tax, and can be addressed only with fairly radical reforms that would tend to equalize the treatment of interest expense and dividends paid, such as increasing withholding taxes applied to interest income or introducing a deduction for dividends paid.
Annex A: An Overview of the METR Methodology

The impact of business taxes on investment is one of the most important areas in the study of taxation. The issue is complicated by the fact that corporate/business tax regimes are very complicated, and differ substantially across jurisdictions and types of capital. One cannot just compare statutory tax rates, but rather one must incorporate tax depreciation (write-off) rates; special investment credits and allowances; other taxes on business capital – property taxes, capital taxes, turnover taxes, capital transfer taxes, etc.; tax holidays, etc.

Economists summarize the key elements of the business tax system with respect to investment in a measure called the Marginal Effective Tax Rate (METR) on capital. The METR is a summary measure of the effective rate of tax imposed on the rate of return generated by the last, or marginal, unit of capital a firm invests in. The METR is therefore a summary measure of the total distortion in the rate of return to capital imposed by the business tax system. It is important to emphasize that the METR on capital reflects only taxes that impose upon the rate of return on capital. Other taxes levied on other inputs into production, such as payroll taxes levied on labor, are not reflected in the METR on capital.

There are four types of distortions caused by business taxes which METRs measure: the higher the METR the greater the disincentive to invest – this is the inter-temporal distortion; METRS can vary across industries - inter-sector distortion; METRS can vary across types of capital (asset) - inter-asset distortion; METRs can vary across jurisdictions (i.e., countries) - inter-jurisdictional distortion.

The purpose of this Annex is to explain the idea behind the calculation of METRs. We begin with a conceptual explanation of the concept, and then move into a slightly more formal discussion.

Conceptual Explanation of the METR

There are two main "stakeholders" that hold an interest in firms: debt holders and equity holders (owners or "shareholders"). In order to satisfy these stakeholders, an investment must earn a rate of return after the payment of all business taxes which is greater than or equal to the (weighted average) "hurdle" rate of return required by these stakeholders. The hurdle rate is the minimum rate of return acceptable to these stakeholders.

For example, say the (weighted average) hurdle rate of return is 10%. This means that all capital projects that earn a rate of return greater than 10%, after the payment of all business taxes, will be undertaken. So, it a firm invests in all projects with a rate of return greater than the hurdle rate, and it invests in projects with the highest rate of return first and then moves down the “menu” of capital
projects available to it, the last (marginal) project undertaken will earn an after-tax rate of return of 10% exactly.

The derivation of the METR formula can be quite complicated, but the idea can be conveyed in a simple example. As above, say the hurdle rate of return is 10% - i.e., the minimum (weighted average) rate of return required by the stakeholders in the project after the payment of all business taxes is 10%. Say the business tax system is such that in order to earn a ROR of 10% after business taxes, an investment must earn a ROR of 15% before business taxes. The METR is then 33.33% (determined as (.15-.10)/.15). The METR therefore measures the share of the investment’s pre-tax required rate of return needed to cover the tax costs associated with the investment.

Note that the 33 1/3% METR could differ substantially from the statutory CIT rate because of the existence of other taxes, deductions, credits, allowances, etc. In general, the METR is higher (the tax distortion greater),

- the higher is the statutory CIT rate and other tax rates - capital taxes, business taxes, property taxes, turnover taxes
- the lower is the tax depreciation rate on capital relative to the "economic" depreciation rate
- the lower are various tax incentives - i.e., investment tax credits
- the lower the proportion of investment financed by tax deductible debt

More Formal Explanation of the METR

Neoclassical investment theory tells us that a firm will invest in capital up to the point where, at the margin, the present value of the after-tax cash flow from the last dollar invested equals one dollar. Therefore the marginal unit of capital just breaks even in the sense that the present value of the cash flows after the payment of taxes just equals the one dollar cost. Thus, for a simple corporate tax system:45

$$1 = \int C(1-u)e^{-(rf-\pi-\delta)t}dt - t + uZ(1+t)$$

where C is the asset’s pre-tax rental rate, u is the corporate income tax rate, rf is the firm’s after-tax nominal discount rate (defined in more detail below), π is the inflation rate, δ is the economic depreciation rate, Z is the present value of the tax depreciation deductions on $1 of capital, and t is the implicit tax rate on $1 of

---

45 For explanatory purposes we impose a very simple corporate tax system here, which ignores various features of many tax systems, such as investment allowances, investment tax credits, turnover taxes, tax holidays, etc. It is relatively straightforward to incorporate these features of the tax system in the expressions. The calculations provided in the text incorporate these features where appropriate.
capital (for example a sales tax imposed on capital, an asset transfer tax, etc.). The left hand side of the equation is the cost of $1 in capital while the right hand side is the present value of the after-tax returns to that marginal unit of capital. The first term on the right hand side is the present value of the after-tax cash flows (net of depreciation) generated by the marginal unit of capital; the second term is the sales taxes paid on that unit of capital; the third term is the value of the tax depreciation allowances.

Integrating this to determine $C$, and subtracting the economic depreciation rate $\delta$, gives the before-tax, after depreciation, rate of return required to cover the firm’s opportunity cost of funds and the taxes associated with the investment, commonly referred to as the user cost of capital:

$$rg \equiv C - \delta = (1+t)(rf - \pi + \delta)(1-uZ)/(1-u) - \delta$$

This is akin to the before-tax hurdle rate of return discussed above.

The user cost of capital as written above clearly reflects the corporate income tax and any sales taxes imposed on capital, which are levied on the demand side of the capital market. Personal taxes levied on the supply side of the capital market can enter the user cost of capital expression through the firm’s discount rate $rf$.

The precise expression for $rf$ depends upon several assumptions concerning the marginal source of funds to the firm and the extent to which capital is internationally mobile. The extent to which capital is mobile internationally, and therefore whether the South African capital market should be thought of as closed or open, or some combination of the two, is a complicated question. It turns out that the assumption that one makes in this regard has a big impact on the expression for $rf$ and important implications for the effect of the domestic tax system on investment.

To deal with this issue, we present several sets of calculations. First, we assume that large corporations operate in a small open economy with internationally mobile capital. This is a common assumption that is made in many METR studies. For small corporations, we take a slightly different approach. First, in order to compare the calculations directly with those of large corporations, we present a set of METRs under the small open capital market assumption. Second, we present another set of METRs for small businesses under the closed capital market assumption. The idea here is that small businesses do not have access to international financial markets, and may therefore be thought of as operating in a segmented, closed market for capital. One might think of the METRs for the closed economy case as the METRs on “entrepreneurial” firms.

As will be shown below, an important difference between the open and closed capital markets scenarios is that in the open economy case domestic personal taxes levied on the return to saving have no impact on the level of domestic
investment. In the closed economy case, on the other hand, domestic taxes levied on the return to savings at the personal level can affect domestic investment undertaken by small firms.

In order to understand the distinction more easily, it is useful to start with the closed economy model and utilize a simple diagram. Figure 1 depicts the market for a homogeneous investment good in a closed economy. The investment demand schedule, I(rg), gives the level of investment as a function of the before-all-taxes (gross-of-tax) rate of return. The savings supply schedule, S(rn) gives the level of savings as a function of the required after-all-taxes (net-of-tax) rate of return. All taxes mean both corporate and personal taxes. In terms of the conceptual framework laid out above, rg is the before-all-taxes hurdle rate of return and rn is the after-all-taxes hurdle rate of return.

Of course in a closed economy the level of saving must equal the level of investment. This means that there is an equivalence between taxes imposed on savings (the supply side) and taxes imposed on investment (the demand side); taxes imposed on both sides of the market impact upon both investment and savings. In equilibrium, given the taxes imposed on both sides of the market, the level of investment and savings in the diagram is Ie=Se, the gross-of-tax rate of return is rg and the net-of-all-taxes rate of return is rn.

In the closed economy case the nominal cost of debt to the firms is the return to debt required to yield rn after personal taxes, given by:

\[ rd = \frac{(rn+\pi)}{(1-Ti)} \]

where Ti is the domestic PIT rate on interest.

Similarly, the nominal cost of equity is given by:

\[ re = \frac{(rn+\pi)}{(1-Te)} \]

where Te is the domestic PIT rate on equity (a weighted average of the tax rate on dividends and the accrual equivalent tax rate on capital gains).

The discount rate facing the firm, rf, is then a weighted average of the cost of debt and equity, given by:

\[ rf = \beta rd (1-u) + (1-\beta)re \]

where \( \beta \) is the debt/asset ratio. This reflects the fact that debt interest’s costs are deductible for CIT purposes, while the cost of equity is not.

The marginal effective tax rate on capital is the share of the before-tax-rate of return (rg) required to pay the taxes on the investment (rg-rn):
METR = (rg – rn)/rg

The METR is therefore the share of the investment’s pre-tax required rate of return needed to cover the tax cost.

In the closed economy model it is important to note that there is an equivalence between supply side taxes on savings and demand side taxes on investment – both lead to a decrease in investment (and savings).

If capital is perfectly mobile internationally and the South African capital market is small in the sense that savings and investment decisions in South Africa have no impact on the “world” interest rate, the link between South African savings and South African investment is broken. This means that the equivalence between taxes levied on investment and taxes levied on savings no longer holds. An important implication of this is that South African personal taxes imposed on savings may have very little impact on domestic investment, though these taxes can still affect domestic savings.

This is most easily seen with reference to Figure 2. In an open economy the after-corporate-tax but before-personal-tax rate of return is fixed by world financial markets. Denote this fixed rate of return in real terms by ri. Demand side taxes imposed on corporate capital increase the before-corporate-tax rate of return required to generate this after-corporate-tax rate of return to rg. Domestic investment in this case is Ie and the METR on capital in an open economy is given by the tax wedge (rg-ri) divided by the gross-of-tax rate of return rg. Supply side taxes imposed on domestic savings decrease the after-personal-tax rate of return to rn, yielding domestic savings of Se. In the case depicted, the excess of domestic investment over domestic savings (Ie-Se) is provided by foreign investment inflows. Importantly, while taxes on domestic savings affect savings and the share of domestic investment financed by foreigner, they have no impact on domestic investment itself (unlike in the closed economy model).

In terms of the user cost of capital framework laid out above, the internationally determined cost of funds determines the firm’s discount rate, rf in the user cost of capital expression given in equation (2). An important consideration here is the identity of the marginal international investor. We assume that the marginal investor is an “average” of investors from G7 countries. If rd is the nominal cost of debt facing the firm, fixed by international markets, then the nominal cost of equity is given by the arbitrage condition that the after-tax return to debt equals the after-tax return to equity, rd(1-Td*)= re(1-Te*) where Td* is the tax rate on debt for the marginal international investor and Te* is the tax rate on equity. Then, in equilibrium the nominal cost of equity facing the firm fixed by international financial markets is:

re = rd(1-Td*)/(1-Te*)
and the weighted average nominal discount rate facing the firm is:

\[ rf = \beta rd (1-u) + (1-\beta) re \]

The after-corporate-tax, before-personal-tax, real rate of return fixed by international financial markets is then:

\[ ri = \beta rd + (1-\beta) re - \pi \]

and the marginal effective tax rate on capital in a small open economy is then:

\[ METR = (rg - ri)/rg \]

All of the above formulas were developed for physical capital, in particular for depreciable capital like equipment and buildings. Non-depreciable capital, such as land, is easily accommodated by setting economic depreciation (\( \delta \)) and the present value of tax depreciation allowances (\( Z \)) equal to zero in the expression for the user cost of capital, \( rg \) (equation (2)), giving:

\[ rg = (1+t)(rf-\pi)/(1-u) \]

For inventory capital the expression for the cost of capital can be shown to be:

\[ rg = (1+t)(rf-\pi+uf)/(1-u) \]

where the parameter \( f \) is equal to 0 if LIFO inventory valuation is used for tax purposes and equal to 1 if FIFO is used. Thus, the use of FIFO inventory accounting is seen to increase the cost of holding inventory capital by virtue of the taxation of the inflationary increase in the cost of inventories.

Also, note that the expressions for \( rg \) developed above ignore various features of many tax systems, such as investment allowances, investment tax credits, turnover taxes, tax holidays, etc. It is relatively straightforward to incorporate these features of the tax system in the expressions, and we do so where appropriate.
Figure A1: Closed Capital Market

Figure A2: Open Capital Market with Internationally Mobile Capital
Issues Illuminated by METR Analysis

The primary applications of METR analysis are twofold. First, the results of an METR analysis show the net effect of all components of the tax system on the level of the taxation of capital income generated by the marginal investment analyzed. Thus, a METR provides a measure of the actual tax burden on a prospective investment attributable to the existing (or proposed) tax system. Moreover, an appropriately weighted average of the METRs on specific types of investments can be constructed to provide a measure of the overall level of taxation of capital income in the economy, showing how the tax system distorts investment decisions (and, if individual level taxes are considered, saving decisions as well) and thus introduces inefficiencies or “excess burdens” into the economy.

Second, by considering a wide variety of investments that differ by asset, method of finance, investor or economic circumstances, METR analysis provides an indicator of the tax differentials that arise across different types of investments, that is, it shows how taxes affect the composition of investment. In particular, a METR analysis shows how the tax system results in a variety of distortions of investment decisions, thus creating additional efficiency losses, beyond those associated with simply taxing capital income at a uniform effective tax rate. The most commonly cited distortion is across types of assets, as differential taxation of different types of assets induces businesses to invest too heavily in tax-advantaged assets and too little in tax-disadvantaged assets. This of course translates into distortions across business sectors, as the tax system favors sectors with production processes that use tax-favored assets intensively and penalizes businesses that use relatively heavily taxed assets intensively. The following subsections discuss these distortions and a wide variety of others, all of which can be analyzed with an appropriately designed METR analysis.

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46 It should be noted that "distortions" of investment decisions must be measured relative to some benchmark. In general, a tax system would not distort investment decisions only if the METR were zero on all types of investment; this would occur, for example, under an ideal consumption-based tax (Zodrow and McLure, 1991). In this case, METR differentials – and the associated distortions of investment decisions – would be measured relative to a benchmark tax rate of zero. However, under an income-based tax, the benchmark level of taxation of capital income is typically the statutory income tax rate. In this case, the distortion of saving/investment decisions implied by the taxation of capital income at the statutory rate is in a sense taken as given, and the distortions attributable to tax differentials are measured relative to the statutory income tax rate. In addition, note that this discussion assumes that efficiency requires a tax system that is neutral across assets. This need not be true. For example, tax differentials may be desirable to correct for negative production externalities (e.g., pollution) or to offset other inefficiencies in the economy (e.g., inefficiencies in the taxation of labor income). These complications are ignored in the analysis, as they are best addressed with specific tax policies as needed (e.g., taxes on effluents or reform of the system of labor income taxation) rather than through the ordinary income tax system applied to capital income; for further discussion, see Gugl and Zodrow (2004).
Distortions of the Level of Investment and Saving

METRs provide an indication of the overall level of taxation of various forms of capital income and thus indicate how the tax system affects investment and saving decisions. Because they consider many aspects of the tax system, METR analyses often give very different results regarding the effects of the tax system on investment decisions than would a simple examination of statutory tax rates (or special preferences) in isolation. Effective tax rates that are far above or below the statutory rate indicate potential areas for reform, as relatively high positive rates act as a deterrent to investment, while negative METRs suggest that the tax system stimulates investments that are socially undesirable because they earn a return lower than the opportunity cost of funds.

Distortions of the Allocation of Investment

METRs are also very useful in identifying the extent to which the tax system distorts investment allocation decisions by asset and by business sector (given the benchmark level of taxation of capital income in the tax system). Apart from the arguments for differential taxation noted above, most public finance economists would argue that competitive markets are generally efficient in allocating resources. The implication of this view is that tax differentials are generally undesirable because the associated distortions of investment allocation decisions result in reduced productivity of investment; that is, a disproportionate amount of capital is allocated to those sectors and assets in which tax treatment is relatively favorable rather than to those sectors and assets where investment would be most productive in the sense of generating output valued by consumers. In other words, the tax system should generally be characterized by "economic neutrality" with respect to investment allocation decisions, or METRs that do not vary according to the type of asset or business sector.

In addition, METR analysis demonstrates the extent to which certain types of preferential treatment confer an advantage to the tax-favored activity. Indeed, METR analysis can be used to determine whether the effects of "preferential" treatment of certain forms of investment are in fact consistent with the intent underlying such treatment. For example, in some cases such as certain types of tax holidays, supposedly preferential treatment results in METRs that are actually higher than those under the ordinary income tax system. Similarly, a preferentially low tax rate in a sector can have the effect of increasing METRs if depreciation deductions and other investment allowances under the regular tax system are sufficiently generous.

Method of Finance

METR analysis is useful in determining whether the tax system favors one form of finance over another. Under a market-based approach to tax reform, such distortions are also undesirable as they imply a tax-induced alteration of the
allocation of risk-bearing in the economy. For example, a tax bias toward debt finance may increase the overall indebtedness of firms and thus increase the likelihood that costly bankruptcies – or perhaps even more costly government bailouts – will be incurred during an economic downturn.

In addition, tax differentials across methods of finance may discriminate against certain types of firms. For example, a tax system that results in an unusually high METR on new share issues will discourage investments by firms that tend to use new issue finance to a disproportionate extent, including new enterprises that have little retained earnings and limited access to debt finance. Again, most public finance economists would argue that neutrality with respect to firm financing decisions is a desirable property of a tax system.

**Choice of Organizational Form**

METR analysis identifies the extent to which the tax system distorts decisions regarding the choice of organizational form. Typically, firms may be organized as corporations subject to the corporate income tax or non-corporate entities that are taxed on a “pass through” basis, with business income attributed to the individual owners and taxed under the personal income tax. Economic neutrality with respect to decisions regarding organizational form is also generally desirable, so that firms may select the form of business organization that best meets their needs without worrying about differential tax consequences.47

**Effects of Inflation**

An important benefit of METR calculations is that they can be used to demonstrate how tax rate differentials, as well as the level of capital income taxation, vary with the rate of inflation. Unless a tax system is completely indexed for inflation, the pattern of METRs will be different for each expected steady state rate of inflation. The fluctuations of METRs with inflation can be considerable, especially for large differences in the expected inflation rate. Note that such variation in METR levels and differentials with inflation adds an element of complexity to investment decisions, as it makes it more difficult to interpret the effects of the tax system on alternative investments. Such uncertainty is likely to reduce the overall level of investment at any given inflation rate.

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47 As in the case of resource allocation, there may be externalities associated with the choice of organizational form; for example, tax enforcement may be less costly for firms that are publicly held corporations.
Annex B: Calculation of marginal effective tax rates

The calculation of METRs is outlined in this Annex. For further details, consult Boadway, Bruce and Mintz (1984) or King and Fullerton (1984). Consider an investment in an asset that costs \( q \), has a marginal revenue product of \( c \), and lasts forever but depreciates exponentially at a constant rate of economic depreciation \( \delta \). Suppose further that the corporate income tax rate is \( u \), the net indirect tax rate on the purchase of the asset (due to non-creditable VATs, customs duties, sales taxes, excise taxes, transaction taxes, etc.) is \( t \) (which is included in the tax basis of the asset), and an initial investment allowance of \( n \) is granted (with no adjustment of basis). Let \( z \) be the present value of the depreciation deductions allowed under the income tax, per dollar of investment, over the life of the asset. For example, if the tax code allows exponential (declining balance) deductions at rate \( \pi \),

\[
z = \int_0^\infty a q e^{-\alpha t} e^{-(\alpha + \pi) t} dt = \frac{aq}{\alpha + r_f + \pi},
\]

where \( r_f \) is the firm's real discount rate and \( r_f + \pi \) is the firm's nominal discount rate where \( \pi \) is the expected steady state rate of inflation. To calculate \( r_f \), assume that the debt-asset ratio is fixed at \( \beta \), the nominal interest rate is \( i \) and the return required by equity holders (which reflects dividends and capital gains) is \( \rho \) in which case

\[
r_f = \beta (1 - u) i + (1 - \beta) \rho,
\]

reflecting the deductibility of interest payments coupled with the lack of deductibility of payments to shareholders. The calculation of a marginal effective tax rate (METR) assumes that a marginal investment in an asset just breaks even, that is, that the net benefits generated by the investment, taking into account all tax factors, just equals the after-tax net cost of the investment. For a depreciable asset this requires

\[
(1 - un)(1 + t)q = (1 - u) \int_0^\infty c e^{-\delta t} e^{-(\delta + r_f) t} dt + u(1 + t)z
\]

\[
(1 - un)(1 + t) = \frac{(1 - u)(c/q)}{\delta + r_f} + u(1 + t)z
\]

\[
c/q = \frac{(1 - un)(1 + t)(\delta + r_f)}{1 - u} - \frac{u(1 + t)z(\delta + r_f)}{1 - u}
\]

The gross return to the asset, net of depreciation, is thus

\[
r_g = c/q - \delta = \frac{(1 + t)(\delta + r_f)}{1 - u} \left[ 1 - u(n + z) \right] - \delta.
\]

For land, the gross return is obtained by setting the depreciation rate in this expression equal to zero. For inventories, the gross return is obtained by setting the depreciation rate in this expression equal to zero and, in the case of FIFO inventory accounting, adding a term to \( r_f \) equal to the product of the corporate tax
rate and the inflation rate to the numerator.\textsuperscript{48} Finally, letting $r_n$ denote the net return to investment, the marginal effective tax rate on the investment is

$$METR = \frac{r_g - r_n}{r_g}$$

\textsuperscript{48}See Broadway, Bruce and Mintz (1982).
Annex C: Assumptions used in cross-country analysis

The data for this analysis are taken entirely from country studies prepared by the International Bureau of Fiscal Documentation for Malawi (2003), South Africa (2003), Tanzania (2002) and Zimbabwe (2004). Since these data are incomplete and may be dated and because not all features of the tax system in each country are considered, the METRs calculated below should be regarded as tentative and used for rough comparison purposes only. As in the base case for Zambia, the calculated METRs reflect business level taxes only and do not consider any withholding taxes on interest or dividends. In addition, all of the countries considered have broadly similar indirect taxes, with creditable VATs with rates that range from 14-20 percent (recall that the standard rate for the VAT in Zambia is 17.5 percent) and have customs duties that typically range from zero to 25 percent (although specific data on how the customs duties apply to capital goods are not available).

Accordingly, the METR calculations simply assume that the same effective indirect tax structure applies in all of the comparison countries as that assumed in South Africa, with machinery subject to an effective indirect tax rate of 20 percent in the financial sector, 10 percent in the agricultural sector, and 5 percent in the tourism and manufacturing sectors, coupled with a 5 percent indirect tax rate on inventories in the tourism sector. These assumptions also help focus the analysis on a comparison of the differences in income taxes across the various countries. The analysis also assumes that FIFO accounting is used in all of the comparison countries – this is explicit in the description of the tax code for South Africa (which bans the use of LIFO), and assumed for the other comparison countries. Finally, all other parameters, such as real after-tax rates of return and debt-equity ratios are assumed to be the same in all countries, with the exception of inflation rates, which reflect recent most recent PPI values of 3.7 percent in South Africa, 9.6 percent in Malawi, 4.4 percent in Tanzania and 51.4 percent in Zimbabwe.

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49 As above, various provisions noted in footnotes are listed for completeness only and are not reflected in the comparison country METR calculations.
### Annex D: Proposed Royalty Schedule: Minerals and Petroleum Royalty Bill

#### Substance Classification and Royalty Rates

<table>
<thead>
<tr>
<th>Group</th>
<th>Substance</th>
<th>Royalty Rates %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Sall, sand, stone, sandstone, slate, gravel, clay, concrete, mortar, plaster, brick, dolomite, limestone, shale, gypsum, limestone, perlite, and phosphate rock extracted by a mineral extractor outside of the exemption described under section 12.</td>
<td>1</td>
</tr>
<tr>
<td>2</td>
<td>Oil and gas: natural gas and natural gas condensate petroleum crude offshore production where the water depths are deeper than 500 meters.</td>
<td>1</td>
</tr>
<tr>
<td>3</td>
<td>Alumino-silicates (andalusite, sillimanite, kyanite), asbestos, ammonium sulphate, barytes, zirconium oxide uranium oxide, kaolin, talc, magnesite, mica, silica, sulphur, sodium sulphite, mineral pigment, pyrophyllite, dimension stone (granite,omite), and perlite.</td>
<td>1</td>
</tr>
<tr>
<td>4</td>
<td>Anthracite and bituminous coal (low ash and steam)</td>
<td>2</td>
</tr>
<tr>
<td>5</td>
<td>Antimony, copper, iron, manganese, lead, zinc, cobalt, nickel, silicon, tin, and vermiculite.</td>
<td>2</td>
</tr>
<tr>
<td>6</td>
<td>Oil and gas: natural gas and natural gas condensate petroleum crude onshore and offshore production where the water depths are shallower than 500 meters.</td>
<td>3</td>
</tr>
<tr>
<td>7</td>
<td>Gold, silver, vanadium, chromite, and titanium dioxide (Ilmenite, rutile)</td>
<td>3</td>
</tr>
<tr>
<td>8</td>
<td>Platinum group metals: platinum, palladium, rhodium, iridium, ruthenium, and osmium.</td>
<td>4</td>
</tr>
<tr>
<td>9</td>
<td>Amethyst, quartz (smoky quartz, citrine, rose quartz), cryptocrystalline quartz (jasper, opal), ol chalcedony (blue lace agate, moss agate, onyx), rainbow chalcedony, tiger's eye, blue asbestos (crocidolite), beryl (emeralds, aquamarine, morganite, heliodor), chrysoberyl (cat's eye, alexandrite), corundum (rubies, sapphires), garnet (jade, hydrogrossular, spessartine), lollite, kyanite, sodalite, sugilite (royal lavulite or royal azel), tourmaline, verdite (serpentine), and topaz.</td>
<td>5</td>
</tr>
<tr>
<td>10</td>
<td>Unpolished natural diamonds</td>
<td>8</td>
</tr>
</tbody>
</table>
# Annex E: Mining Companies Total Effective Tax Rate: International Comparison 2004

<table>
<thead>
<tr>
<th>Gold</th>
<th>Country</th>
<th>Pretax Income (million US$)</th>
<th>Statutory Tax Rate</th>
<th>Effective Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barrick</td>
<td>Canada</td>
<td>45</td>
<td>37.8%</td>
<td>(451.1%)</td>
</tr>
<tr>
<td>Goldfields</td>
<td>SA</td>
<td>142</td>
<td>46.0%</td>
<td>6.2%</td>
</tr>
<tr>
<td>Glamis Gold</td>
<td>USA</td>
<td>27</td>
<td>32.5%</td>
<td>21.7%</td>
</tr>
<tr>
<td>Harmony</td>
<td>SA</td>
<td>(130)</td>
<td>45.6%</td>
<td>36.5%</td>
</tr>
<tr>
<td>Lihir Gold</td>
<td>PNG</td>
<td>315</td>
<td>30.0%</td>
<td>(4.7%)</td>
</tr>
<tr>
<td>Newmont</td>
<td>USA</td>
<td>1099</td>
<td>35.0%</td>
<td>25.1%</td>
</tr>
<tr>
<td>Placer Dome</td>
<td>Canada</td>
<td>144</td>
<td>35.6%</td>
<td>(90.3%)</td>
</tr>
<tr>
<td>Other Metals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Alcoa</td>
<td>USA</td>
<td>2204</td>
<td>35.0%</td>
<td>25.3%</td>
</tr>
<tr>
<td>BHP Billiton</td>
<td>Australia</td>
<td>4518</td>
<td>30.0%</td>
<td>23.1%</td>
</tr>
<tr>
<td>Freeport</td>
<td>USA</td>
<td>574</td>
<td>35.0%</td>
<td>57.6%</td>
</tr>
<tr>
<td>Implats</td>
<td>SA</td>
<td>639</td>
<td>30.0%</td>
<td>27.7%</td>
</tr>
<tr>
<td>INCO</td>
<td>Canada</td>
<td>1168</td>
<td>39.9%</td>
<td>36.8%</td>
</tr>
<tr>
<td>Kumba</td>
<td>SA</td>
<td>224</td>
<td>30.0%</td>
<td>30.1%</td>
</tr>
<tr>
<td>Resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minara</td>
<td>Australia</td>
<td>172</td>
<td>30.0%</td>
<td>0%</td>
</tr>
<tr>
<td>Resources</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Phelps Dodge</td>
<td>USA</td>
<td>1389</td>
<td>35.0%</td>
<td>10.2%</td>
</tr>
<tr>
<td>Rio Tinto</td>
<td>UK</td>
<td>3596</td>
<td>30.0%</td>
<td>23.4%</td>
</tr>
<tr>
<td>Trans Hex</td>
<td>SA</td>
<td>47</td>
<td>30.0%</td>
<td>36.6%</td>
</tr>
<tr>
<td>Xatrata</td>
<td>Switz.</td>
<td>1369</td>
<td>26.0%</td>
<td>12.9%</td>
</tr>
</tbody>
</table>

### Annex F: Marginal Effective Tax Rates on Capital

South Africa and Comparator Countries, Manufacturing and Services Sectors, Large Corporations, Current System

<table>
<thead>
<tr>
<th></th>
<th>Canada</th>
<th>Australia</th>
<th>New Zealand</th>
<th>India</th>
<th>Kenya</th>
<th>Tanzania</th>
<th>Uganda</th>
<th>Zambia</th>
<th>South Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MANUFACTURING</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>45.4%</td>
<td>34.1%</td>
<td>34.2%</td>
<td>24.3%</td>
<td>40.1%</td>
<td>17.7%</td>
<td>14.5%</td>
<td>-2.7%</td>
<td>25.6%</td>
</tr>
<tr>
<td>Machinery</td>
<td>28.2%</td>
<td>26.5%</td>
<td>30.3%</td>
<td>17.5%</td>
<td>15.4%</td>
<td>2.5%</td>
<td>13.3%</td>
<td>20.7%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Land</td>
<td>19.9%</td>
<td>8.5%</td>
<td>9.1%</td>
<td>6.2%</td>
<td>-9.2%</td>
<td>19.3%</td>
<td>5.3%</td>
<td>-450.8%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>36.7%</td>
<td>30.1%</td>
<td>23.2%</td>
<td>35.4%</td>
<td>41.4%</td>
<td>19.4%</td>
<td>21.1%</td>
<td>63.4%</td>
<td>32.4%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>35.5%</td>
<td>29.4%</td>
<td>30.1%</td>
<td>23.2%</td>
<td>29.3%</td>
<td>10.7%</td>
<td>15.1%</td>
<td>30.3%</td>
<td>21.3%</td>
</tr>
<tr>
<td><strong>SERVICES</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buildings</td>
<td>39.4%</td>
<td>25.5%</td>
<td>25.1%</td>
<td>15.1%</td>
<td>20.6%</td>
<td>12.1%</td>
<td>13.1%</td>
<td>1.1%</td>
<td>17.1%</td>
</tr>
<tr>
<td>Machinery</td>
<td>44.4%</td>
<td>18.4%</td>
<td>33.3%</td>
<td>28.3%</td>
<td>24.3%</td>
<td>3.8%</td>
<td>16.1%</td>
<td>27.5%</td>
<td>18.8%</td>
</tr>
<tr>
<td>Land</td>
<td>19.9%</td>
<td>8.5%</td>
<td>9.1%</td>
<td>6.2%</td>
<td>-9.2%</td>
<td>19.3%</td>
<td>5.3%</td>
<td>-450.8%</td>
<td>5.3%</td>
</tr>
<tr>
<td>Inventories</td>
<td>36.9%</td>
<td>30.1%</td>
<td>23.2%</td>
<td>35.4%</td>
<td>41.4%</td>
<td>19.4%</td>
<td>21.1%</td>
<td>63.4%</td>
<td>32.4%</td>
</tr>
<tr>
<td>Aggregate</td>
<td>41.1%</td>
<td>22.1%</td>
<td>28.8%</td>
<td>24.9%</td>
<td>21.0%</td>
<td>9.6%</td>
<td>15.5%</td>
<td>14.3%</td>
<td>17.5%</td>
</tr>
</tbody>
</table>
### Comparator Country Tax Incentive Regimes 1/

<table>
<thead>
<tr>
<th>South Africa</th>
<th>Kenya</th>
<th>Uganda</th>
<th>Tanzania</th>
<th>Zambia</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Country-wide 2/</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax incentives</strong></td>
<td>Tax holiday for firms incorporated between 1996-1999. Other incentives such as SME development program for manufacturing sector firms (up to ZAR 3 million), other SME support, and a skills support program. DTI lists 90 different types of fiscal and non-fiscal incentives</td>
<td>There is no codified investment scheme in Kenya to attract investors, but incentives do exist in the form of various allowances and waivers of import duty, which can be negotiated individually with the Ministry of Finance.</td>
<td>Investors can qualify for duty and sales tax drawbacks by satisfying three of the following criteria: the generation of new earnings or savings of foreign exchange through exports, resource-based import substitution or service activities; using local materials, supplies and services; creating employment opportunities in Uganda; introducing advanced technology; contributing to locally or regionally balanced socio-economic development. These drawbacks are also extended with foreign capital investments over USD 500,000 and domestic investments over USD 50,000.</td>
<td>No CIT tax holidays, other tax incentives given to priority and lead sectors (see below)</td>
</tr>
</tbody>
</table>

| Corporate income tax | Basic rate: 30%, concessional rates for mining | Basic rate: 30% | Basic rate: 30% | Basic rate: 30% | Basic rate: 35%--45% for financial sector in excess of K 250 million, ad hoc reductions for some sectors |
| VAT rate (general) | 14% | 16% | 17% | 20% | 17.5%, deferments for specific items, VAT only applicable for firms turnover over minimum threshold |
### II. Regional

#### Specific regions with incentives
- Foreign trade zones, export zones, industrial development zones offers new investments fiscal incentives. New eligible firms receive tax free status (in grant form) for 3 years
- Benefits available to EPZ enterprises include exemption for excise duties, exemption from corporation tax and withholding tax for 10 years, exemption from stamp duty, and a 100% investment deduction.
- Rural areas eligible subject to 15% CIT.

### III. Sector Specific

#### Specific sectors with incentives
- Mining (copper, cobalt): CIT 25%, agriculture 15%, nontraditional exports, 15%. Capital allowances especially in ag, tourism, manufacturing, (50% per annum). Duty exemptions for capital equipment imported by mining company. VAT zero ratings for exports, tour packages.
- “Priority Areas” include processing of crops, forest products, meat and fish, banking, steel, chemicals, textiles and leather, oil milling, paper, mining, glass and plastic, ceramics, manufacture of tools, equipment and industrial spare parts, construction and building materials manufacture, tourism, real estate development, packaging, transport, energy conservation, pharmaceuticals, and high technology.
- Investment allowances for priority and lead sectors (manufacturing, resources, financial services, transport, forestry, agriculture, high tech. Mining, tourism). All pay 30% CIT, but all receive 0 duty status for imported inputs, 100% capital allowance, VAT deferment or exemptions.
- Basic rate: 35%, 25% for mining, 10% for manufacture in growth industries, 20% other manufactures which export, 20% tourism

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1/ Comparitor country data obtained during desk study from International Bureau of Fiscal Documentation Country Reports, various years & should be used for reference only. Zambia information is current as of September 2004 & does not include proposed incentive changes.
2/ All countries in this list have double taxation agreements.
## I. Country-wide 2/

<table>
<thead>
<tr>
<th>Tax Incentives</th>
<th>Canada</th>
<th>Australia</th>
<th>New Zealand</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian-controlled corporations can apply for an income tax credit of up to 35% on certain expenses related to R&amp;D; most tax incentive programs are carried out on the provincial level.</td>
<td></td>
<td>Australia’s Strategic Investment Coordinator accepts applications for tax relief, which are evaluated based on economic benefit, contribution to Australia’s areas of competitive advantage, long-term viability, and other factors. Deductions are available for certain activities involving R&amp;D (up to 125%) and environmental impact assessment. A tax credit of 20% of approved expenditure on heritage conservation is available as well.</td>
<td></td>
<td>New export-oriented undertakings are eligible for exemption from income tax; deductions are available for infrastructure facilities (100%), small-scale industrial startups (25%), and capital expenditure on research &amp; development (dependent on sector and activity).</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>Basic rate: 21%</td>
<td>Basic rate: 30%</td>
<td>Basic rate: 33%</td>
<td>Basic rate: 35%, 12.5% for life insurance businesses</td>
</tr>
<tr>
<td>VAT rate (general)</td>
<td>GST: 7%</td>
<td>GST: 10%</td>
<td>GST: 12.5%</td>
<td>Cenvat: 16%, Sales Tax: 4%</td>
</tr>
</tbody>
</table>
II. Regional

| Specific regions with incentives | Certain businesses in Newfoundland, Prince Edward Island, New Brunswick, Nova Scotia and the Gaspé Peninsula are eligible for tax credits related to property (10%) and R&D (20%) expenses. | Industrial startups in Free Trade Zones, technology parks and the Northeastern Region eligible for exemption; 100% deduction is available for those in “backward areas.” |

III. Sector Specific

| Specific sectors with incentives | Investors in the production of certified Canadian films and videotapes are eligible for full or partial tax exemption depending on residency of funding sources. | Write-offs are available for amounts invested in Australian films, as well as exemption of receipts from such films up to a certain percentage of the amount invested. | Deductions are available for certain expenditures by firms in the farming, forestry, aquaculture and mining sectors. | Tax holidays available for telecoms (10 years), power (5 years), and mineral oil (7 years); Profit deductions available for housing (100%), cold chain facilities (100%), shipping (50%), plantation crops (40%), poultry farms (33%) and tourism (15%). |

1/ Comparitor country data obtained during desk study from International Bureau of Fiscal Documentation Country Reports, various years & should be used for reference only. Zambia information is current as of September 2004 & does not include proposed incentive changes.
2/ All countries in this list have double taxation agreements.
Annex G: Description of the tax system in South Africa used in the METR calculations

The following is a description of the features of the taxation of capital income under the tax system of South Africa. The description is not meant to be comprehensive; rather, the focus is on the tax provisions that are relevant to the calculation of METRs at the business level on four capital assets (machinery, buildings, inventories, and land) and on five business sectors (manufacturing, tourism, agriculture, financial services and mining) as well as small businesses subject to specific tax rates and sometimes exempt from VAT.

Tax Rates

The standard rate under the corporate income tax is 29%. Rates in the mining sector (where gold mines are taxed under an optional formula) are estimated via a weighted average of gold and non-gold mining. Small businesses pay a lower rate of corporate income tax (discussed in the text) and this is modeled accordingly.

Depreciable Assets

In general, deductions for depreciation on machinery are allowed on a straight-line basis over a period of four years. However, for the agriculture, tourism and manufacturing sectors, accelerated deductions are allowed – as described in the text. In no case are deductions for depreciation indexed for inflation. Expenditures related to prospecting and capital development assets in the mining sector are expensed.

Commercial buildings cannot in general be depreciated. However, industrial buildings are depreciated on a straight-line basis over twenty years. Thus, the buildings used by the manufacturing, agriculture, mining and tourism sectors are treated as industrial buildings. In addition, the METR analysis assumes that the buildings used by the financial sector are also industrial buildings.

Inventory Accounting

The cost of inventories must be calculated using the “First-In, First-Out” or FIFO method for tax purposes. The impact of a move to LIFO accounting is also modeled. Inflation is presumed at 3.7% (the most recent producer price inflation figure available at the time the model was built).

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50 The term “machinery” will refer to the category “equipment, plant and machinery” in the South African income tax law.
51 The mining industry may also pay government royalties in the future. Scenarios including royalty payments are computed separately.
52 The calculations follow the standard approach of using exponential depreciation at twice the straight line rate to approximate the value of these straight line deductions.
Value Added Tax (VAT) and Import Duties

In general, purchasers of capital goods are allowed full credit for any VAT paid (although in some cases the VAT on imported goods is deferred (not collected upon import) so that no credit is necessary. The primary exception to this rule is the standard problem that any VAT on capital goods cannot be credited by businesses that are exempt from the VAT, including most small businesses, the producers of exempt goods (primarily agricultural producers of exempt products), and the financial sector (although certain activities of this sector, such as leasing, are subject to VAT). In addition, although import duties are assessed at rates that range up to 15 %, most capital goods are either exempt from such duties (e.g., those imported by the mining sector) or are taxed at a 5 % rate. On the other hand, some capital goods, such as motor vehicles and certain hotel supplies, apparently are taxed as finished goods and thus subject to a 25 % excise tax rate. It is obviously very difficult to translate this treatment into an effective indirect tax rate that should be applied to capital goods. The METR calculations simply assume that for the sectors analyzed indirect taxes are important primarily for investment in machinery, and that the effective indirect tax rates are 20 % for the financial sector, 10 % for the agricultural sector, and 5 % for the tourism sector. In addition, excise taxes are likely to be important for the tourism industry, especially if some inputs for the tourism industry are treated as final consumption goods; the calculations arbitrarily assume that the indirect tax rate on inventories in the tourism sector is 5 %.

Withholding Taxes

Since this analysis is focusing on business-level METRs, the only withholding taxes of potential interest are those applied to the Secondary Tax on Companies, applied at 12.5%. The dividend payout ratio is set at 50%.

Special Provisions Applicable to Small Businesses

The Small Business Corporations (SBCs) corporate income tax provisions in SA are restricted to corporate entities with annual gross income not exceeding R6 million. Theses firms benefit from a graduated tax rate, with 0% applied up to taxable income of R35,000, 10% on taxable income in excess of R35,000 and up to R250,000, and the full 29% rate on taxable income in excess of R250,000. Note that SBCs must pay the STC on dividend distributions, regardless of their taxable income. Registered, tax-paying small manufacturing businesses are able to write-off machinery and equipment immediately, at 100%, rather than the typical write-off rate of 20% per annum (5 years straight line). Other, non-manufacturing, SBCs can write equipment off at a 50:30:20% rate over three years.
Inflation

South Africa has a fairly good record on inflation. The METR calculations assume a producer price inflation of 3.7% - the most up to date available figure at the time the model was constructed.

Other Parameters

The calculations assume that the real rate of interest is fixed which, given the domestic inflation rate associated with a major world currency such as the US dollar or the euro, can be used to calculate the nominal interest rate as determined in international markets. This real rate of return is set at 4%, and the fixed real return to equity assumes an equity premium of 5%. Economic depreciation is assumed to be exponential, using fairly standard if somewhat conservative rates of 14% for machinery and 3% for buildings. The debt / asset ratio is assumed to be 40%.

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53 To determine the nominal interest rate in South Africa, the real interest rate is adjusted for the producer price inflation rate ($\pi$) in South Africa (equal to 3.7% ($\pi=0.037$) in October 2005 - in the base case simulations) by a factor equal to $\pi/(1-u)$, where $u$ is the corporate tax rate, to reflect the deductibility of interest under the corporate income tax. This yields a nominal interest rate of 7.8%, roughly consistent with, although generally somewhat lower than, recent nominal short term interest rates in South Africa.

54 Although these figures are plausible, they are nevertheless quite tentative since there are no data on actual depreciation rates in South Africa.
REFERENCES


