



FREE MARKET FOUNDATION

PO Box 4056 | Cramerview 2060
011 884 0270 | gailday@fmfsa.org

Free Market Foundation submission on TAX

To: Committee 1 (Triple Challenges of Inequality, Poverty and Unemployment)
High Level Panel on the Assessment of Key Legislation

By: Free Market Foundation

1. The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

2. General comments on taxation and its impact on growth and poverty

In the current anaemic economic growth environment government may be tempted to raise taxes in order to bolster its coffers but the best way to stimulate growth is allow people to work, save and invest. It is common knowledge that taxes penalise a targeted activity. For example, taxes on alcohol, cigarettes, fuel, imports, etc, are imposed to curb the consumption of such items. Similarly, taxes imposed on income and earnings reduce the source of that funding. They diminish the incentives and zeal of entrepreneurs to risk capital and sacrifice time and energy, they interfere with the ability of individuals to pursue their goals, they send workers home with smaller disposable incomes. Less disposable income means less saving, less saving means less capital formation, less capital formation means lower labour productivity, and lower labour productivity means lower real wages thus completing a vicious cycle.

3. Recommendations

Flat Tax

A proportional or flat tax, as opposed to a progressive tax system, is one in which the ratio of tax to taxable income is the same at all levels of income. It replaces the various tax bands that feature in a progressive tax regime with a single rate. A "true" flat tax makes no provision for exemptions and provides no special dispensation for low-income earners. However, there is no merit whatsoever in taxing the poor for compassionate reasons, which are obvious, and for the practical reason that the costs of collecting taxes from those below a certain level of income will exceed the amount collected. Low-income earners should, therefore, be exempt from paying tax on personal income. A low flat tax would not only be fair, but also broaden the tax base, improve incentives to invest, make tax evasion more difficult and less lucrative, increase economic growth, raise local investment by encouraging capital formation, and create new jobs by increasing real wages.

VAT

Governments impose taxes for one of two reasons - either to curb consumption of the targeted activity or to raise revenue. The tax on pharmaceutical products, therefore, must be levied purely to raise revenue because it is counterintuitive for the government, if it wants a healthy and productive workforce, to tax the sickest and most vulnerable members of our society. Accordingly, we are of the view that VAT on all pharmaceutical products and devices should be zero-rated.

Small Business

Tax is one of the greatest inhibitors of small business development. The high level of taxes, the enormous volume and complexity of the tax laws, and the administrative sophistication required to comply with these laws are daunting even for well-educated entrepreneurs. For anyone, who, through no fault of their own, was educationally deprived, it would be easier to climb Mount Everest without oxygen than to understand and comply with the tax laws. There is an urgent need for simplification and preferably also for a reduction in tax rates. Until there is serious tax reform, that great and well-proven engine for wealth and job creation, the small firms' sector, will continue to splutter and choke, economic growth will be curtailed, unemployment will continue to rise, and social instability will worsen.

BEPS

The OECD explicitly argues for more international harmonisation of the corporate tax base to make it easier for countries to tax corporations worldwide. These calls should be rejected. Colluding to maintain corporate tax is neither necessary nor appropriate. The world continues to become more interconnected and countries will use their various comparative advantages to compete in order to attract multinational enterprises. Rather than conspiring to adopt a one size-fits-all policy, the South African government should consider the option of switching to a better-designed and more simplified tax system.

Estate Duty

The evidence tells us that the best way to achieve economic and political objectives is not always obvious. It may seem like a good idea to increase taxes on the wealthy but such an action invites considerable uncertainty. The people who are more often than not the worst hit by estate duty are not South Africa's wealthiest individuals who are more likely to conceal their wealth through perfectly legal (and sometimes illegal ways), but middle income South Africans. They are the risk-takers in society who have spent a lifetime pouring sweat equity into their small and medium-sized businesses. They become anguished and enraged when they discover that their reward for a life of virtue is to have their life time savings which they have built up to bestow upon their children and grandchildren, reduced, upon their death, by a confiscatory tax. This is morally wrong given that this tax is imposed on rands that had already been taxed when the income was earned during the deceased's lifetime. The FMF views estate duty as one of the most pernicious and immoral forms of double taxation and recommends that it be repealed in toto.

Attachments

These attachments were originally prepared as submissions to the **Davis Tax Committee**.

1. Macro Analysis
2. Flat Tax (three attachments)
3. VAT
4. Small Business
5. BEPs
6. Estate Duty



FREE MARKET FOUNDATION

Johannesburg

PO Box 4056 | Cramerview 2060
Tel 011 884 0270 | Fax 011 884 5672
Email fmf@mweb.co.za

Cape Town

PO Box 805 | Cape Town 8000
Tel 082 941 5375
Email tembanolutshungu@fmfsa.org

Durban

PO Box 17156 | Congella 4013
Tel 031 572 3308 | Fax 031 572 3308
Email jassonurbach@fmfsa.org

31 August 2015

Comments to the Davis Tax Committee (DTC)

on the

DTC's First Interim Report on Macro Analysis

Introduction

The FMF is grateful for the opportunity to submit these comments on the DTC's Macro Analysis Framework First Interim Report Discussion Document¹ dated June 2015 entitled "*The Tax System and Inclusive Growth in South Africa: Towards an Analytical Framework for the Davis Tax Committee*". We make reference below the Full Report, and also to its well-considered Executive Summary.²

The First Interim Report is merely a discussion document for developing a framework for analysis. However, we are compelled to disagree with the assumptions throughout the Report that a progressive income-tax system entails increasing tax brackets, that reducing inequality necessitates progressive tax rates and that fairness and equity depend on increasing tax brackets.

We stress that the Hall/Rabushka system flat tax system maintains tax equity and provides for progressive taxation by means of the initial exemption threshold. It is lamentable that the Report's references to a flat-tax system are reduced to footnotes.

¹ We refer to the Discussion Document as the "Report", the "Full Report" or the "Macro Analysis First Interim Report (Full)".

² DTC, Macro Analysis Framework First Interim Report, Executive Summary, June 2015. We refer to it as the Summary Report.

Economic growth

We hail the Committee's flexible approach in recognising there is no conventional framework for designing a system to grow the economy and allow the increased prosperity to be enjoyed by all.³

We support the principle in the Report that overall a tax system must support economic growth.⁴

We respectfully submit that a flat tax system with an exemption for the first part of income, as proposed by the FMF,⁵ would best achieve the overarching principles for inclusive growth articulated in the Report.

Minimise distortion, broaden tax base, a low tax rate

We support the principle in the Report that a tax system should minimise distortion in the allocation of resources, and the recognition that in general there is least distortion when a tax is applied to broad bases with low rates.⁶

We concur with the Report's observation that a broader tax base would foster and create incentives for greater government accountability and responsiveness to citizens, since government depends on them for revenue.⁷ The Report asks how the tax system can be altered in order to encourage the formalisation of the informal sector.⁸

We submit that the Hall/Rabushka system flat tax system with a low tax rate would broaden the tax base and make tax evasion more difficult and less lucrative. Low flat taxes minimise the economic distortions caused by taxes. Distortions lead to lost output and high costs pursuing tax-beneficial investments.⁹

As Hall and Rabushka observe, graduated tax rates create different tax rates among taxpayers, with attendant opportunities for leakage. High-income taxpayers have the biggest incentive and best opportunity to exploit tax-rate differentials. Applying the same tax rate to these taxpayers for all their income in all years is an important goal of flat-rate taxation.¹⁰

Under systems such as America's, or those operating in most of western Europe, the incentives for the rich to avoid tax (legally or otherwise) are enormous; and the opportunities to do so, which arise from the very complexity of the codes, are commensurately large. So it is unsurprising to discover, as experience suggests, that the rich usually pay about as much tax under a flat-tax regime as they do under an orthodox code.¹¹

³ Full Report p 4.

⁴ Full Report p 4.

⁵ Free Market Foundation, Submission to the Davis Tax Committee, January 2014.

⁶ Full Report p 4.

⁷ Summary Report p 3.

⁸ Full Report p 90.

⁹ FMF, Submission to the DTC, January 2014.

¹⁰ Robert E Hall and Alvin Rabushka, "The Flat Tax in 1995", January 1995, p 3. Hoover Institution, Stanford University.

¹¹ *The Economist*, 14 April 2015, "The flat-tax revolution: Fine in theory, but it will never happen. Oh really?"

The Report does not rule out a flat tax system.¹² It remarks on the evidence that flattening the personal income tax schedule could be beneficial for stimulating GDP per capita by favouring entrepreneurship, and the evidence about the economic effects of flat taxes from the experiments in certain countries.¹³

Tax equity, fairness and progressivity

As the Report states, income tax can be a progressive form of raising revenue: the level of income determines the amount of the tax, and the poorest are not taxed.¹⁴ Overall, according to the National Development Plan, the personal income tax is a progressive form of raising revenue as the level of income determines the amount of the tax, so that the poorest are not taxed.¹⁵

We reiterate that tax equity is maintained in the Hall/Rabushka system by exempting the poor, indeed everyone, from income tax on the first part of income.¹⁶ Progressive taxation does not require a number of different tax rates. The progression is created by providing the initial exemption threshold. Such a flat rate system is progressive, counter-intuitive as it may appear to some.

Messrs Hall and Rabushka stress that it is not necessary for a progressive tax system to have rising marginal rates. The key is to provide each taxpayer with a personal allowance and to tax all income above that allowance at the one rate. The allowance constitutes a threshold of taxation: taxes are imposed on income above the threshold and exempted below the threshold.¹⁷

Hall and Rabushka explain that exempting the poor from taxes does not require graduated tax rates rising to high levels for upper-income taxpayers. A flat rate applied to all taxpayers above a generous personal allowance provides progressivity without having to create differences in tax rates.¹⁸

By way of illustration, take a tax system with a 10% flat rate on all income over R10,000 a year, the first R10,000 being tax free. If a person makes R10,000, his tax rate is 0%. If he makes R20,000 then his tax bill is R1,000 ($R20k - R10k \times 10\%$) or 5%, and if he makes R100,000 then his tax bill is R9,000 ($R100k - R10k \times 10\%$) or 9%. These are rising average tax rates without needing to have a rising marginal one. This flat tax with an allowance is enough to meet the condition of its being a progressive tax system.¹⁹

(We accordingly respectfully disagree with the assumptions in the Report that a progressive income-tax system entails different and increasing tax brackets:

(We disagree with the implicit assumption behind the Report's statement that reducing inequality necessitates progressive "tax rates" for high incomes.²⁰

¹² Full Report p 64 fn 11.

¹³ Full Report p 64 fn 10.

¹⁴ Full Report p 10.

¹⁵ National Development Plan to 2030, *Our future - make it work*, p 344 (2012). See full report p 74.

¹⁶ FMF, Submission to the DTC, January 2014.

¹⁷ Robert E. Hall, Alvin Rabushka, *The Flat Tax*, 2d ed, 2007, Chapter 2, "What's Fair about Taxes?" p 48.

¹⁸ Robert E Hall and Alvin Rabushka, "The Flat Tax in 1995", January 1995, Hoover Institution, Stanford University. Page 4.

¹⁹ The average tax rate will asymptotically approach the flat tax rate itself as income rises. *Forbes*, 18 March 2014, "Bill Gates Points to the Best Tax System, the Progressive Consumption Tax" (T Worstall).

²⁰ Full Report p 70.

(We would also differ with the Report's assertion that fairness and progressivity is dependent not only on the tax-free threshold but also on how quickly "income tax brackets increase" as taxable income rises.²¹

(We also disagree that flattening the personal income tax schedule of rates implies a trade-off between growth and equity.²²)

Redistribution on the expenditure side

The DTC observes that, while progressivity in the overall tax system is an important consideration, a great deal of redistribution happens on the expenditure side of the budget.²³ While the Report says tax-reform initiatives should be guided by the general principle that, among other things, the overall tax system should remain progressive, it remarks that redistribution is often more effective through appropriate government expenditure programmes.²⁴

The Report, in evaluating the current South African tax system against the principles of a good system, observes that the personal-income-tax reforms over the last two decades have not really resulted in an improvement of income distribution.²⁵ It also notes some consensus that personal income taxation is not a very suitable instrument for redistribution purposes in developing countries.²⁶

Companies should be taxed at the same low flat rate as individuals

The Report states that relying less on corporate income taxes relative to personal income taxes could increase efficiency. It says however that lowering the corporate tax rate substantially below the top personal income tax rate could jeopardise the integrity of the tax system, as high-income individuals would attempt to shelter their savings within corporations, trusts and other legal entities.²⁷

We submit that the government should consider simplifying the tax dispensation by having a zero rate for individuals below a certain threshold and a low flat tax rate of perhaps 15 per cent for everyone else including companies.²⁸

The system would tax all income as an integrated system, applying the same low flat rate to businesses and individuals, thereby removing the incentive for individuals to utilise companies and other legal entities to reduce tax.²⁹

Forty jurisdictions, large and small, developing and developed, administer a flat-tax system.³⁰

The Hall-Rabushka flat tax is in effect a consumption tax. It treats the total amount of investment as an expense in the year it is made. Every act of investment in the economy ultimately traces back to an act

²¹ Full Report pp 74 – 75. Summary Report p 9.

²² Full Report pp 63 – 64.

²³ Full Report p 95, concluding remark §16.2.a.

²⁴ Full Report p 88 – 89.

²⁵ Full Report p 86.

²⁶ Full Report p 86, citing Steenekamp, T. "The Progressivity of Personal Income Tax in South Africa since 1994 and Directions for Tax Reform," [2012] 16(1) *Southern African Business Review*, pp 39 – 57.

²⁷ Full Report p 63.

²⁸ FMF, Submission to the DTC, January 2014, p 7.

²⁹ FMF, Submission to the DTC, January 2014, p 8.

³⁰ FMF, Submission to the DTC, January 2014, pp 10 – 11.

of saving. A tax on income with an exemption for saving is in effect a tax on consumption, for consumption is the difference between income and saving.³¹

Gary Moore
Consultant to FMF

The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction and human welfare. As a think-tank the FMF's fundamental approach to policy questions is consumer-based. Individual consumer choice is placed at the centre of any policy recommendations that the FMF espouses. Consumer satisfaction is generally achieved by an absence of barriers to entry into the provision of goods and services, allowing consumers a choice between the offerings of freely competing providers, and the absence of regulations that impose avoidable costly burdens on the providers of goods and services.

³¹ Robert E. Hall, Alvin Rabushka, *The Flat Tax*, 2d ed, 2007, Chapter 3, "The Postcard Tax Return" pp 108 – 109.



FREE MARKET FOUNDATION

PO Box 4056 | Cramerview 2060
011 884 0270 | gailday@fmfsa.org

Free Market Foundation submission on INTRODUCING A FLAT TAX

To: Committee 1 (Triple Challenges of Inequality, Poverty and Unemployment)
High Level Panel on the Assessment of Key Legislation

By: Free Market Foundation

1. The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

2. South Africa should adopt a flat tax

Eastern European countries, most notably Russia, have made their economies more competitive by adopting low, flat tax rates. Russia cut its tax rate to a flat 13% in 2000 and almost doubled its tax receipts as a percentage of GDP in 2001. Estonia (26%) and Latvia (25%) led the way in the 1990's, but were less bold in cutting the rate. However, they are remarkably successful, with average growth rates of 6.1% in 2002. The Slovak Republic is introducing a 19% flat tax this year and Iraq's top tax rate is to be slashed from 45% to a flat 15% for individuals and businesses.

Low flat taxes reduce compliance costs and minimise the economic distortions caused by taxes. Taxes change the behaviour of citizens and tax systems that are designed to have the least negative effect on their behaviour allow economies to achieve the best results.

If the flat tax system developed and refined by economists Robert E Hall and Alvin Rabushka of the Hoover Institution, USA, were to be adopted by South Africa it would simplify South Africa's tax system to such an extent that it would be understood by the vast majority of taxpayers. The system taxes all income at a low flat rate and has various features that reduce complexity:

- A generous personal allowance that exempts the poor from income tax.
- Two postcard-size tax returns, one for Business Tax and another for Individual Wage Tax.
- An integrated system applying the same rate to businesses and individuals, removing the incentive to utilise companies and Close Corporations to reduce tax.
- Consumption is taxed and saving is not because all investment spending is removed from the tax base.
- There are no special allowances.
- Fringe benefits are not deductible by businesses or taxable in the hands of employees.
- Capital equipment, structures and land purchased by businesses are deductible when purchased and taxable when sold.
- Interest paid is not deductible as a business expense and interest received is tax-free in the hands of recipients.
- A flat rate of about 19% would raise the same amount of federal revenue for the American government as their existing complex system.
- The draft tax act prepared by the authors to replace the existing U.S. federal tax laws is 3½ pages long, compared to over 2000 pages of basic tax law and 10,000 additional pages of tax regulations.

South Africa is a developing country and needs to simplify its laws and administration to enable its citizens to understand and cope with them. A 3½-page tax act and 13% flat tax – perhaps 18% if VAT is abolished – would be a great improvement. Citizens should be allowed to concentrate their minds on earning a living and not be forced to waste their time and hard-earned money dealing with time-consuming complexity. A simple, low, flat tax system would lift the burden of the current system yet raise the same amount of revenue, given the propensity of low tax rates to raise unexpectedly high revenues, as predicted by Arthur Laffer and demonstrated by Russia.

A highly complex progressive tax system costs as much as 62% of actual taxes received by government. While wealthy countries may be able to afford this waste, South Africa cannot. Our developing economy has too many serious socio-economic problems to resolve and should seek to cut waste to a minimum. As demonstrated by the Eastern European countries, and by Hong Kong which introduced a low flat tax many decades ago, increased economic efficiency, reduced compliance costs and lower tax rates have substantial positive effects on economies.

Many newspaper columns have been filled with reports on tax evasion and how SARS is dealing with the issue. Yet the evidence shows that the best way to reduce tax evasion is to reduce the tax rates. Taxpayers who are risk-takers will evaluate the risk of being caught against the benefit gained from tax evasion. As tax rates are reduced, more and more people will choose to pay the taxes rather than risk the penalties imposed on evaders.

An estimated 500,000 American lawyers, accountants and other professionals make a living out of U.S. tax laws. Even if South Africa's numbers are not in the same proportion to total population, we could still have in the region of 40,000 professionals living off the tax laws. Introducing a simple flat tax would allow these highly skilled people to do something more productive.

South Africa's tax system is not yet as complex as that of the U.S. but it is unfortunately moving in that direction. Tax systems should be adapted to accommodate citizens, rather than have the citizens change or incur high costs to accommodate the tax system. Hall and Rabushka propose an integrated flat tax that applies to both businesses and individuals but with separate half-page tax forms for the two types of taxpayer. All businesses, whether owned by companies, close corporations, partnerships or individuals would complete the same tax form. This is the kind of simplicity we need in South Africa to accommodate the thousands of emerging entrepreneurs who have great difficulty in dealing with the current complexity.

Tax equity can be maintained by exempting the poor from income tax. Exempting everyone from tax on the first part of income could do this. This way the poor pay zero and the wealthiest continue to pay the highest average rates. For example, if the exempted income is R60,000 per year and the tax rate 13%, a person earning R60,000 would not pay tax, on R100,000 the tax would be R5,200 (6.5%), and on R2 million it would be R252,300 (12.61%). The Hall/Rabushka system would be fair, broaden the tax base, improve incentives to invest, make tax evasion more difficult and less lucrative, increase economic growth, raise local investment by encouraging capital formation, create new jobs by increasing real wages and improving incentives to work, reduce interest rates immediately, encourage taxpayers to be more honest, and attract foreign investment.

Attachments

1. The flat tax system: A descriptive analysis
2. Postcard-size tax forms

RESEARCH PAPER

**THE FLAT TAX SYSTEM:
A DESCRIPTIVE ANALYSIS**

**THE DEPARTMENT OF ACCOUNTING
RHODES UNIVERSITY**

**RESEARCH PAPER SUBMITTED
IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE
POSTGRADUATE DIPLOMA IN TAXATION**

BY

JANET PAVEY (602P2130)

SUPERVISOR: PROF. E. STACK

16 DECEMBER 2005

Abstract

The objective of the research paper was to describe flat tax by examining the nature of a flat tax system, different opinions held on the feasibility of a flat tax system and the experience of countries that have adopted such systems. As the field of research was wide, the scope of the research was limited to a descriptive study and the method used was to conduct a literature review of the topic in accordance with the objectives and to conduct two informal interviews. The data generated was mostly in the public domain and ethical considerations were minimal. It was found that proponents of flat tax state numerous reasons as to why a flat tax system would be advantageous to a country, while critics of the system state many reasons as to why it would not work. Economic freedom was shown to be an important factor that needs to be taken into consideration, as it is said to encourage growth within an economy. Reduced tax rates are said to increase economic freedom. Countries that have introduced a flat tax system have generally produced good results, including growth in the economy and in revenue collections. This is not necessarily due to the introduction of flat taxes, as other factors need to be considered. These countries have continued to levy flat taxes and, over time, have decreased the rates at which they are levied. This indicates that flat taxes are achieving certain goals. It would appear that South Africa is unlikely to adopt a flat tax system in the near future.

Acknowledgements

Many thanks go to all who helped with this project. Special thanks go to Mr E. Davie and Ms O. Matshane for their input into this paper. A big thank you to Prof. Stack who helped and encouraged me so much.

Contents Page

<u>Contents</u>	<u>Page</u>
<u>Chapter One - Introduction</u>	5
1.1. Context of the research	5
1.2. Goals of the research	6
1.3. Methodology and data	6
1.4. What is flat tax?	7
1.4.1. A single flat tax rate	7
1.4.2. Elimination of specific preferences	7
1.4.3. No double taxation of saving and investment	7
1.4.4. Territorial taxation	8
1.4.5. Family-friendly	8
1.4.6. Consumption-based	8
1.5. The Hall-Rabushka System	9
1.6. Equity, efficiency and simplicity in relation to tax	10
1.6.1. Equity	11
1.6.2. Efficiency	12
1.6.3. Simplicity	12
1.7. Conclusion	13
<u>Chapter Two - Opinions of various writers on the flat tax system</u>	14
2.1. Introduction	14
2.2. Opinions on the flat tax system and economic freedom	14
2.2.1. The proponents of the flat tax system	14
2.2.1.1. Increase in tax revenue from lowering the tax rate - advantages of a flat tax system	15
a) Incentives and the Laffer Curve	15
b) Risk versus reward	17
c) Increased compliance	18
d) Simplicity and administration costs	18
2.2.1.2. Other suggested advantages of a flat tax system	19
a) Minimisation of economic distortions	19
b) Competitive advantages – attracting investment and global competitiveness	20
c) Promotion of entrepreneurs	21
d) Broadening the tax base	22

e) Economic growth	23
2.2.2. Critics of the flat tax system	23
2.2.2.1. A study on risk versus reward and compliance	23
2.2.2.2. Emotive language	24
2.2.2.3. Arguments made against flat tax	24
a) The definition of income	24
b) Flat tax would work only in smaller, less developed economies	24
c) The wealthy would pay less tax	25
d) Job losses	25
2.2.2.4. Proponents' answers to the critics	25
a) The definition of income	26
b) Flat tax would work only in smaller, less developed economies	26
c) The wealthy would pay less tax	26
d) Job losses	27
e) Vested interests in the tax system	27
2.3. Economic freedom and its role in tax	27
2.4. Conclusion	33
Chapter Three - a discussion of flat tax countries	34
3.1. Introduction	34
3.2. Flat tax countries	34
3.2.1. Hong Kong	36
3.2.2. Estonia	37
3.2.3. Lithuania	38
3.2.4. Latvia	38
3.2.5. Russia	39
3.2.6. Serbia	41
3.2.7. Iraq	41
3.2.8. Ukraine	42
3.2.9. Slovakia	42
3.2.10. Georgia	43
3.2.11. Romania	43
3.2.12. Poland	43
3.3. Other countries that are thinking of reducing their tax rates	44
3.4. South Africa and flat tax	45
3.5. Conclusion	47

<u>Chapter Four - a summary and further areas of research</u>	48
4.1. Summary	48
4.2. Further Research	52
<u>Bibliography</u>	54

Chapter One: Introduction

1.1 Context of the research

A good taxman “so plucks the goose as to obtain the most feathers for the least amount of hissing,” said Jean-Baptiste Colbert who was treasurer to Louis XIV (The Economist, 2005b:63).

The idea of flat tax has been around for many years, but due to the many criticisms of the system and perhaps the vested interests held, the major economies of the world have resisted implementing it. However, in recent years, the criticism that flat tax could never work, has had to be rethought due to the number of countries that have recently adopted the system and that, up to now, seem to be prospering. This has put a new light on flat tax and has revived the idea that a flat tax system could be the system to revolutionise the collection of revenue both from individuals and companies.

This has rekindled the interest of many of the major economies including China, Spain and Germany who are starting to look at the feasibility of a flat tax system (The Economist: 2005a) (Mitchell: 2005b). Flat tax could thus start to play a large role in the world economy if more countries, especially countries with more economic power, start to adopt a flat tax. The question remains whether flat tax has helped these economies to grow or whether other factors have played a part. Whatever the answer, the world is starting to debate a previously unpopular idea.

Assuming that, with further research, a flat tax system is proved to be beneficial to an economy and that flat tax countries continue to produce good results, South Africa would then have to seriously consider this system. The more countries that adopt this system of tax and produce good results, the more pressure there will be on other countries to adopt the system. If this is so, a flat tax system would help a country keep up with a world economy, including perhaps encouraging investment and entrepreneurial growth.

1.2 Goals of the research

The goals of this research are:

- To describe what a flat tax is;
- To carry out a literature review on flat tax in order to discover and discuss the different opinions that are held about flat tax;
- To uncover the weaknesses and strengths of the flat tax system, based on this literature review;
- To discuss the role and importance of economic freedom in the field of taxation;
- To briefly explore some of the flat tax systems that have been implemented in other countries; and
- To briefly explore the possibility of South Africa adopting flat tax.

1.3 Methodology and Data

The research was of an exploratory nature. It aimed to provide a basis from which further research could be done. As the research field was very wide, the main objective of the research project was to describe the nature of a flat tax.

A literature review was done in order to gather data in relation to the goals set out above. This data was assembled, analysed and discussed, including the weaknesses and strengths of flat tax according to the proponents and critics of the system. Two unstructured interviews were conducted to identify potential sources of data and to gain a clearer understanding of the proposed research from different professional viewpoints. Most of the data was in the public domain, therefore no ethical considerations arise from such data. Data gained from the interviews was cross checked with the parties involved at a later stage in order to check the accuracy of the opinions as stated and to adhere to ethical considerations.

1.4 What is flat tax?

Probably the most discussed flat tax system is the Hall-Rabushka system that was first proposed to America in 1985 (Basham et al: 2001). However, this is just one kind of flat tax system out of many different variations and types of systems that have been proposed. While all systems are not identical, they have many common elements. The common elements that most flat tax systems share include (Mitchell: 2005a):

1.4.1 A single flat tax rate

The rate of tax is generally reduced to a single rate that is often lower than the tax imposed by any previous systems of tax. Even the flat tax system, however, is not completely flat as the system recognises a need for a primary rebate. Thus the flat tax system promotes a two-bracket system for individuals, the first bracket being at zero percent tax and the second being at the flat tax rate decided upon (Dunn:2004).

1.4.2 Elimination of specific preferences

Eliminating specific preferences largely serves to reduce the complexity of a flat tax system by removing the sections from the tax act that give special treatment to certain taxpayers. A flat tax system tends to eliminate many, if not all, deductions and exemptions that are offered by a different tax system, for example, a graduated income tax system such as South Africa's current system. This would mean that all fringe benefits and many other deductions would fall away under a flat tax system (Mitchell: 2005a).

1.4.3 No double taxation of saving and investment

Flat tax aims to reduce the complexity of a taxation system and promote the capital growth of an economy. This would include doing away with any bias in the Taxation Act that exists against capital formation. Part of the solution proposed is to tax income that is saved or invested only once. It is suggested that this would also make the collection of tax simpler, promote the growth of capital and create jobs (Mitchell: 2005a). A flat tax only taxes a taxpayer once.

1.4.4 Territorial taxation

A flat tax system taxes only the income that is earned within the borders of a country. This means that there is no residence-based taxation but that the income is taxed in the country where it is earned (Mitchell: 2005a).

1.4.5 Family-friendly

A flat tax system would generally provide for an exemption of tax depending on the size of the family. The bigger the family, the larger the exemption. This means that large families only start paying tax when they earn more than small families (Mitchell: 2005a). In South Africa, this would be an interesting element of flat tax to introduce due to many families being fairly large. An issue that might need to be examined is how this factor of flat tax, were it to be introduced, would influence population growth within South Africa.

1.4.6 Consumption-based

A consumption tax does “not discriminate against saving and investment...regardless of whether taxes are deducted from the paycheck or collected at the cash register” (Mitchell, 2005a). A flat tax system falls into the category of a consumption-based tax system as it taxes income at a low rate and only once as the income is earned. In this way, the system is not biased against saving and investment. Another type of tax that falls into the category of a consumption-based tax is a sales tax system which taxes income at a low rate and only once, but as the income is spent.

Both of these tax systems are different to South Africa’s current one. South Africa has many different types of tax, including asset tax or wealth tax. Examples of these taxes are Estate Duty tax and Capital Gains tax. “Expensing” also occurs within South Africa as many assets have to be depreciated over a period of time and cannot be deducted in full in the year the asset is bought (Mitchell, 2005a). This, according to

Mitchell (2005a), causes an overstatement of income. All these taxation systems mentioned above would, in a pure flat tax environment, be done away with.

1.5 The Hall-Rabushka System

According to Hall and Rabushka (1985:2), there are four objectives of a taxation system. These are:

- To “raise sufficient revenue to support government operations”
- To “encourage socially desirable behaviour”
- To “distribute the costs of government equitably”
- To “foster economic growth, stability and efficiency”

The Hall-Rabushka system proposes that all the elements of a flat tax system mentioned above will help to fulfil these objectives. It proposes that a flat rate of 19 percent with a fairly large primary exemption for individuals would be adequate for America to gain the same amount of revenue as it does currently. They also suggest that the 19 percent not only be put into place for individuals, but also for companies. Thus the system proposed is an integrated system. It suggests that “people are taxed on what they take out of the economy, not what they put into it” (Hall and Rabushka, 1985:40). Thus, “all income is taxed, but the earnings from saved income are not taxed further” (Hall and Rabushka, 1985:42). They also suggest that the graduated tax system, which both America and South Africa have, creates a bias towards too much consumption and not enough saving.

It has also been suggested by flat tax proponents that to have one integrated system would reduce the incentive for people to use companies to avoid tax (Davie: 2004) (due to the lower tax rate imposed on companies). The business tax proposed by Hall-Rabushka suggests that business tax be collected at its source. This means collecting the tax that “owners of a business owe on the income produced by the business” (Hall and Rabushka, 1985:46).

According to the Hall-Rabushka system there would no longer be a distinction between capital and revenue for tax purposes. "Capital gains ... would be taxed under the proposed business tax" system (Hall and Rabushka, 1985:58). In this system, "the purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale" (Hall and Rabushka, 1985: 58).

1.6 Equity, efficiency and simplicity in relation to tax

Every tax system aims to meet three main criteria (Hall and Rabushka: 1985):

1. Efficiency;
2. Equity; and
3. Simplicity.

The question that needs to be raised is how well our current South African system of taxation and the flat tax system satisfy these three aspects.

In 1985, Hall and Rabushka suggested a flat tax system for America. This system, they held, would improve the current American system in all three aspects. The major aspect that would be appealing would be simplicity, as America has thousands of pages of tax law that need to be negotiated and this proposed system would reduce that law to under ten pages. It would also reduce the tax forms that a taxpayer has to fill in every year to a postcard-sized form that the average taxpayer could fill in without help. This proposal would affect everyone paying and involved with tax.

One of the foundations of tax are Adam Smith's four maxims of tax. These maxims need to be examined (Weiner: year unknown):

1. That every citizen of a country should contribute a sum to support the country that as closely as possible reflects their ability and the extent to which they enjoy the protection of their government.
2. The time, amount and manner of the payment should be set and not subjective.
3. The taxpayer should be levied tax in the most convenient manner in order to pay it.

4. Every tax should aim to both take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the State.

These four maxims were used to give guidelines as to the best tax system for an economy and can be summarised as the need for equity, simplicity and efficiency. These are the three aspects mentioned by Hall and Rabushka.

1.6.1 Equity

Equity or fairness is an important aspect of taxation that needs to be carefully examined. Equity means “equal treatment of equals” (Hall and Rabushka, 1985:3). Thus, two families earning the same amount, according to the theory of equity, should pay the same amount of tax. There are two recognised types of equity, horizontal equity and vertical equity.

Horizontal equity occurs where people in a similar economic position pay the same amount of tax. A flat tax, according to Hall-Rabushka, would meet this requirement as “Every taxpayer bears taxes in direct proportion to his income” (Hall and Rabushka, 1985:4).

Vertical equity deals with the taxpayer’s ability to pay tax. This suggests that people who earn more should pay a greater fraction of tax. A theory that underlies this form of equity is that taxation can be used as a tool to re-distribute income between the rich and the poor. The extreme form of vertical equity is where the wealthy taxpayer not only pays more tax in absolute Rand terms, but also pays proportionally more (Hall and Rabushka: 1985). The flat tax theorists claim that flat tax does have progressivity as the wealthy would pay more tax than the poor, however, they suggest that all taxpayers, the wealthy included, should pay a tax proportional to the amount that they earn. Progressivity means that when a taxpayer has a greater income, he pays more tax than a person earning a lower income (Hall and Rabushka: 1985).

Vertical equity fails if taxpayers find loopholes (for example, tax havens) in the system. It is generally the wealthy that have access to the expertise needed to find these loopholes and flat tax theorists claim that there are a significant number of wealthy people in this category. This, they claim is high due to a high rate of taxation. (See the section in Chapter Two on Increased Compliance).

1.6.2 Efficiency

Efficiency occurs where taxation does not distort the balance between investment and consumption. It is suggested that a taxation system should aim to distort prices as little as possible. Hall-Rabushka claim that a high tax rate would distort prices in an economy and would “erode incentives to work, save and invest” (Hall and Rabushka, 1985:3). Hall-Rabushka state that “An efficient system of taxation would collect money without seriously influencing individual decisions on how to work and to save and where to invest” (Hall and Rabushka, 1985:3).

1.6.3 Simplicity

Simplicity is one of the biggest draw cards of flat tax. The tax law within South Africa, in the writer’s opinion, is extensive and fairly complex and seems to have reached the point where many taxpayers are no longer able to fill out their tax forms by themselves. The tax return form that needs to be filled in by taxpaying individuals is many pages long and generally requires some expertise. Flat tax proponents suggest that much time is lost on filling out tax forms and dealing with tax complexities. They also suggest that money is lost on consulting tax advisors in order to take advantage of the legal tax-saving devices.

Flat tax proposes that the tax return form need only be postcard-sized (one for individuals and one for companies) and that the Tax Act would be reduced to under ten pages were it to be implemented. They suggest that a taxpayer or even a large corporate organisation, would not have to seek professional advice in tax matters, but would be able to understand and fill in the taxation form unaided.

A question that needs to be considered is whether the same amount of revenue could be collected from this system and whether it would be a comprehensive system. It can be argued that in lowering the rate of taxation and also doing away with the bracket system of tax and simplifying the system, the government would not be able to achieve an adequate revenue collection to run the country. Flat tax proponents, however, suggest that this is not the case and that in fact more revenue would be able to be collected when the rate is lowered. This concept is discussed further in Chapter Two.

Other factors that should be looked at in considering simplicity is the simplicity of the administration of the taxation laws and the ease of compliance. Less money would be spent in a flat tax environment as it is suggested that by simplifying the system, the cost of enforcing the system is less, as well as the cost of each taxpayer complying. It is suggested that more money would be channelled back into the economy in this environment and that the system would also encourage foreign investment due to the simplified and lower taxation rates.

1.7 Conclusion

This chapter has given a brief introduction to the topic of flat tax. It has described the context of the research, set out the goals of the research and set out the methodology that was followed by the researcher. Furthermore, this chapter has given a brief description as to what a flat tax is and some common features of many types of flat tax systems. It has also described the importance of the role of equity, efficiency and simplicity within a taxation system.

The following chapters will deal with the opinions held about the flat tax system and will discuss what the perceived advantages and disadvantages are. The importance of economic freedom will also be discussed, especially in relation to flat tax. Countries that have introduced a flat tax system will be briefly examined in order to determine whether the flat tax system seems to be working as flat tax supporters suggest that it will. A brief discussion will be given on the likelihood of South Africa adopting a flat tax. Further ideas for research will be suggested.

Chapter Two: Opinions of various writers on the flat tax system

2.1 Introduction

Chapter One described the context and the research goals, the research method and design, and briefly set out the main aspects of a flat tax system. This chapter provides a summary of the opinions of a number of writers on the feasibility of a flat tax system.

2.2 Opinions on the flat tax system and economic freedom

There are many arguments both for and against a flat tax system as well as different ideas on how to implement this system. Both sides of the argument need to be taken into careful consideration. Flat tax proponents state that flat tax would benefit a country's economy by helping it to grow and that more revenue could be collected if the rate of tax is dropped. The critics of the flat tax system state a number of reasons why the proposed flat tax system would not work. Another factor that could play a part in the growth of a country is economic freedom. The role tax plays in determining economic freedom is examined, as well as the degree of economic freedom of various flat tax countries as compared with South Africa.

2.2.1 The proponents of the flat tax system

Hall and Rabushka (1985) and other flat tax proponents claim that flat tax brings in the same, if not more, tax revenue while lowering and flattening the rate of tax. This, at first glance, seems to be contradictory. Hall and Rabushka (1985) claim that this would happen partly due to all the hidden costs of tax collection and tax advice that, under a flat tax system, would not be needed, as well as due to lower tax evasion levels.

Many economists, including the Free Market Foundation (Davie: 2005), believe that incentives are a very important aspect of any economy. Incentives can also play a role in the field of taxation. This also helps to explain the paradox that has been

experienced in some areas in the world: when tax rates have been cut, tax revenues have increased.

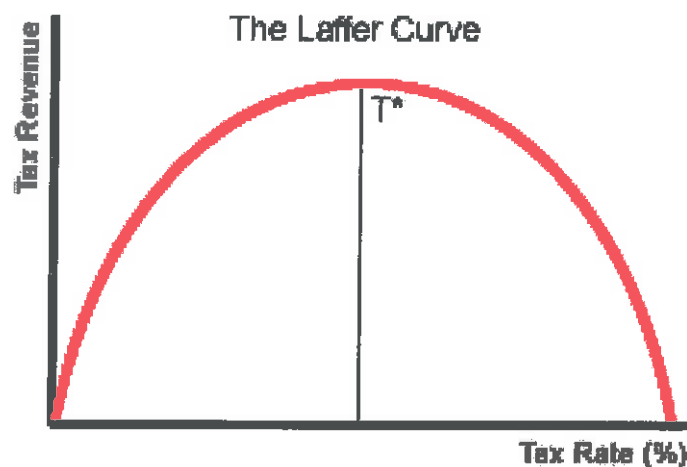
There are a couple of suggested reasons for this paradox that will be dealt with. These include the theory behind incentives and risk versus reward, the suggestion that flat tax will cause an increase in compliance and the suggested increase in the simplicity of the system itself and the administration thereof.

There are many other suggested advantages to the flat tax system, besides those mentioned above, that the proponents of flat tax suggest will occur if the system were to be implemented. Some of these include the minimisation of economic distortions, increased foreign investment causing global competitiveness, the promotion of entrepreneurs, the broadening of the tax base and economic growth.

2.2.1.1 Increase in tax revenue from lowering the tax rate – advantages of a flat tax system

a) Incentives and the Laffer Curve

If one examines the incentives behind tax, there are two rates of tax where the government will earn no revenue. The first rate is where tax is at 0 percent, and the second is where the rate of tax is at 100 percent (Davie: 2005). The government will earn no revenue when tax is at 100 percent because there is no incentive for a person to work when they are getting nothing in return. This must mean that somewhere between 0 percent and 100 percent is an optimal tax level at which the government will receive the most money. (Sturgeon: year unknown). This occurs where the tax rate is high enough to bring in revenue but low enough not to impact a person's incentive to work harder and gain more. This concept is explained and expressed by the Laffer Curve (named after Arthur Laffer). T^* on the Laffer Curve represents the optimal level of tax (Investopedia.com:2005).



Copyright 2008 - Investopedia.com

The Laffer Curve does not state the particular rate of tax that is optimal as this will vary from country to country. It has been suggested that the only way to find out whether a particular economy is between 0 percent and T^* or T^* and 100 percent is to decrease or increase the tax rate and see what happens (Sturgeon: year unknown).

A low rate of tax is said to increase “the reward of extra effort and risk taking” (Pirie, 2005:13). This means that earning becomes more attractive and people are willing to work harder. It has also been suggested that in this way, if tax rates are reduced, the wealthy would pay more tax. There have been a number of examples of countries that have decreased their tax rate and gained more tax revenue.

One example is the tax cuts that occurred in the UK in the 1980’s. Before the tax cuts, the top 10 percent of earners were contributing 32 percent of the tax revenue collected. After the tax cuts, the amount contributed by the wealthy increased to 45 percent of the tax revenue (Pirie: 2005). This seems to show that lowering the rate of taxation can cause the wealthy to contribute more tax. Jonathan Gruber and Emmanuel Saez (2000) suggest that because of higher income earners having “more discretion over the amount, timing and form of their income, they are more responsive to changes in marginal tax rates”. They suggest that this responsiveness is approximately a third more than middle income earners. This would mean that a

decrease in rate (if between T^* and 100 percent on the Laffer curve), would cause the wealthy to pay more tax.

A study done on behalf of the Joint Economic Committee of the US Congress by economist Richard Vedder discovered that when states within the United States drop their tax rate by 1 percent, “real per capita personal income growth increases by 3.6%” (Roubik: year unknown). This helps to explain why a decrease in tax rates can cause an increase in both tax revenues and in per capita gross domestic product (GDP).

For an increase in tax revenue to help to improve an economy, however, federal spending needs either to stay the same or to increase to a lesser extent than the revenue increase. Without this, a country will go into debt.

An example of where this issue occurred was in America during the Reagan administration. The taxation revenues increased, however the rate of growth in federal spending was not curbed. Thus, “while the income tax revenues increased substantially, federal spending increased even more” (Sturgeon: year unknown). This caused the country to go into debt.

Examples of where tax revenues increased when tax rates were cut also include many countries that have introduced flat tax. These countries are discussed at a later point.

b) Risk versus reward

The discussion of incentives should be taken into consideration in the context of risk versus reward. Generally speaking, the more reward there is in a situation, the more people are willing to accept risk in order to gain the reward. If tax rates decrease, there is a greater reward for working harder and risking more. The tendency thus, will probably be towards risking more (Pirie: 2005). The incentive will therefore be provided for the wealthy to risk more and to work harder.

Another instance where risk versus reward plays a vital role is in tax evasion. A risk-taking taxpayer will weigh up the benefit of evading tax against the risk of being caught and the repercussions that may arise. When the tax rate is high, the reward of evading tax is great and thus, generally, more people will evade (illegal) or avoid (legal) tax (Davie: 2004). This is discussed further in the following paragraph.

c) Increased compliance

Another reason for the increase in tax revenues would be where the rate is sufficiently low so as to increase compliance. This is considered to be one of the advantages of a flat tax system. J Blundell, who is the general director of the Institute of Economic Affairs in London, states that: "the best remedy for tax evasion - indeed the only proven way of discouraging it - is to reduce taxes and simplify the tax system." (Blundell: 2002). This was one of the key factors that caused many of the previous communist countries to adopt a flat tax system. These countries, according to Bartlett (2003), were previously unable to collect the revenue needed to run their countries due to tax avoidance and evasion. One example of where this was happening is Russia (Wall Street Journal: 2003). "In every case, implementation of a flat tax system caused collections to rise, as the benefit of evasion was reduced" (Bartlett: 2003). A study done on the Russian tax system found that the reduction of rates and the introduction of a flat tax system produced a "marked increase in tax compliance" (Ivanova et al, 2005:40). They, however, suggest that other factors present in the economy could also have played a role in the increase in tax compliance found.

A critic of the flat tax system, John Kay, suggests that proponents of the flat tax system are "right to argue that elaborately graduated rate structures add little to the progressivity of a tax system but a lot to both opportunities and incentives for tax avoidance" (Kay, 2005:11). This seems to indicate that the case for a flat tax system increasing compliance is a strong one.

d) Simplicity and administration costs

It has been stated by E Davie (2004:12) that "a highly complex progressive tax system costs as much as 62% of actual taxes received by the government". If this figure is

correct, it would mean that approximately 38% of taxes collected are being used for things other than to collect taxes. The costs of administration within the US are speculated to be “between 10% and 20% of revenue collected” (The Economist, 2005c:9). This is a huge administrative cost to any country and South Africa falls into the category of having a progressive tax system. The administrative costs in the case of South Africa may not be as high as these speculated figures, but even if they are lower, the country needs to look for a solution to the possible high expenditure of administration of our current tax system. Spending less on administration would increase the tax revenues that could be used for other things within the economy.

A flat tax system would cost a lot less to administer than a progressive system as there are not as many laws and loopholes to understand and exploit (Absa: 2005). The other obvious advantage that flat tax gives is the simplicity that would allow the average citizen to understand the tax laws and to fill in their own tax forms without any assistance from experts in the field (Davie: 2004). This would save many citizens the money that would be spent on tax advice.

Thus, flat tax could help to increase tax revenues due to its simplicity and the ease of compliance and the decrease in administration costs.

2.2.1.2 Other suggested advantages of a flat tax system

Other suggested advantages of a flat tax system can also help to increase the revenue gained while the tax rate is decreased.

a) Minimisation of economic distortions

A paper on the “fundamental reform of personal income tax” states that taxes, through incentives, may influence various areas within the economy (Working Party No.2 on Tax Policy and Tax Statistics: 2005). They suggest that taxes could also play a role in the incentives to save and invest and could affect labour supply and demand decisions. This influence that the tax system has upon the economy could distort the economy in a negative manner. “Moreover, everything else being equal, such costs tend to increase more than proportionally with the tax rates - implying that the

negative effects of tax distortions will more than double if the tax rates are doubled” (Working Party No.2 on Tax Policy and Tax Statistics, 2005:4).

E Davie (2005) suggests that tax provides a disincentive to enterprise and also states that low taxes reduce the economic distortion caused by tax systems (Davie: 2004). He further states that “taxes change the behaviour of citizens and tax systems that are designed to have the least negative effect on their behaviour allow economies to achieve best results” (Davie, 2004:12). Thus, a taxation system has an important effect on an economy.

It should be remembered, however, that taxation is only one of the many factors that influence an economy and how people will spend their money. The main factor that needs to be taken into account is that of “market forces” (Working Party No.2 on Tax Policy and Tax Statistics, 2005:6). These forces influence how people spend their money before taxation comes into play. Other factors that could influence how taxpayers spend their money include the exchange rate, politics, international agreements (Working Party No.2 on Tax Policy and Tax Statistics, 2005:7) and the overall global situation.

b) Competitive advantages – attracting investment and global competitiveness

Increased levels of investment could come in the form of local or international investment. Felicity Duncan (2005) states that it is not just the success flat tax has achieved in increasing compliance, but also in increasing investment, that has caught the world’s attention.

“In a global economy, it is increasingly easy for jobs and capital to escape high-tax nations and migrate to low-tax nations” (Mitchell: 2005a). This means that there is a benefit to having a low-tax system that will cause an increase in investment. Global competition plays more of a role in our economy as the years progress due to the increased competition for capital and human and financial resources between countries (Mitchell: 2005a). This means that the tax system of a country can no longer only be examined purely in light of that particular country, but it must be examined with global competitiveness in mind.

Globalisation is now not only “desirable but essential, especially for developing economies” such as South Africa (Davie, 2004: 12). Flat tax proponents claim that a lower and simpler rate of tax would encourage foreign investors to enter the country in question. This would be due to the greater reward that would be gained for the risk in investing within a country (Pirie: 2005).

c) Promotion of entrepreneurs

According to Nesvisky (2001), a study was done in the United States on whether growth in an entrepreneur’s business could be related to a decrease in the rate of tax. While it was believed that a tax system could have an influence over the entrepreneur, until this study, there was little proof. Thousands of income tax returns filed by sole proprietors in 1985 and in 1988 were analysed, as between these years, there was a decrease in the marginal tax rate from 50 percent to 33 percent. It was found that this decrease in the sole proprietor’s marginal tax rate caused an increase in the size of their business by about 28 percent (Nesvisky: 2001).

However, not all businesses survived the three year span. This, according to Nesvisky, is not unusual as many small businesses that are started do not survive. The study found that a “decrease in tax rates do not greatly affect survivorship probabilities” (Nesvisky: 2001).

It was found, however, that “the greater the decrease in the sole proprietor’s marginal tax rate between 1985 and 1988, the greater the increase in the size of his or her business” (Nesvisky: 2001). The study further discovered that “the growth-inhibiting effect of taxes on sole proprietorships is a general and pervasive phenomenon” and is not limited to a particular industry or to the personal profile of the particular entrepreneur (Nesvisky: 2001).

A simple system of taxation would also benefit entrepreneurs as they would not have to spend money that they have earned on advice on filling out tax returns and having the Taxation Act explained to them. They would instead be able to fill out and understand their tax form without external help. This would enable the business to

save the money and time that would have been spent and to invest it back into the company, which would probably give the company a better chance of success.

d) Broadening the tax base

In many respects, the concept of broadening the tax base has already been explained. The tax base is expanded under the flat tax system in two main ways (Absa: 2005). The first reason that proponents of the flat tax system state for this effect, is that the low rate of tax increases the compliance of taxpayers, thus increasing the revenue gained. The second reason is that, in theory, the increased reward of the flat tax system will cause a person within the economy to take more risks. It will also cause this person to “keep a higher proportion of whatever they earn and save, making it more attractive to generate additional earnings” (Absa, 2005:1). This will increase the amount of economic activity generated. “Both the higher compliance and the expansion of economic activity contribute to broadening the tax base” (Pirie, 2005:13).

The advantage of broadening the base of tax is that more people are contributing to the tax revenue of a country, thus more revenue should be able to be collected. “Base broadening may also help to reduce tax distortions” (Working Party No.2 on Tax Policy and Tax Statistics, 2005:4). This would, according to many economists including, the Free Market Foundation (Davie:2005), improve the efficiency of the economy and create a situation where the tax system causes less of a negative effect upon the economy. The removal of the distinction between capital and revenue that is suggested by the Hall-Rabushka flat tax system would also help to broaden the tax base.

“Because income inequality is extreme, all personal income tax and most revenue is collected from a small proportion of the population” (Aaron and Slemrod: 1999). This means that South Africa’s tax base is fairly narrow. A broadening of the tax base could thus help South Africa.

e) Economic growth

Proponents of the flat tax system say that flat tax would grow a country's economy (Mitchell: 2005a). This would be due the increased economic activity that flat tax would promote and due to encouraging both local and foreign investment within the country. Flat tax would not "eliminate the damaging impact of taxes altogether" (Mitchell: 2005a), but it would introduce a lower rate which would lessen the effect of any bias against investment and saving. A simpler tax code would also allow more money and time to be spent on running a business and furthering the economy rather than filling in tax forms and getting tax advice. The simplification of the taxation Act would also, according to Dr D. Mitchell (2005a), increase the fairness of the system as the average citizen would be able to handle his or her own tax affairs.

2.2.2 The critics of the flat tax system

There are many people against the idea of a flat tax system. These people believe that the flat tax system is not everything that it is claimed to be and that there are problems with many aspects of the system, not least of which is the implementation of the system. Studies have been done in order to determine what the effects of a flat tax system are on some aspects of the economy. These studies have had interesting results.

2.2.2.1 A study on risk verses reward and compliance

The main study found by the researcher on the introduction of a flat tax system was an International Monetary Fund Working Paper on "The Russian Flat Tax Reform" (Ivanova et al: 2005). This paper sought to discover what the impact of the introduction of a flat tax system was on "tax revenue, work effort, wage rates, and taxpayer compliance" (Ivanova et al, 2005:4). The conclusion of this study, however, seems to indicate that the increased incentives to work, that the proponents of flat tax advocate will happen under a flat tax regime, will not necessarily happen. It was found that the tax rate reduction in Russia did not increase the incentive for people to work harder. The incentive for increased compliance, however, was found to increase under the new (and current) Russian tax system and tax revenues did increase

(Ivanova et al: 2005). There could be many reasons for these conclusions, not just the implementation of a flat tax regime. Further details of this study are discussed in Chapter Three, in the discussion of Russia.

2.2.2.2 Emotive language

Many of the articles written by people who are against the flat tax system are written in highly emotive language. This makes finding the facts and theories as to why a flat tax system is wrong hard to come by. One of the examples of this is Scott E. Hisko who wrote a book on why a flat tax system would not work for America. He stated that his reason for writing was to “dispel the many myths that have been promulgated by the Flat Tax proponents”(Hisko, 1996: xi). He goes on to state that his goal in writing was to promote the current system within America while “exposing the proponents of the Flat Tax for what they are, a bunch of super wealthy, greedy prima donnas who don’t want to pay their fair share” (Hisko, 1996:xii). It can thus be seen that the introduction of a flat tax system is a fairly controversial topic for some.

2.2.2.3 Arguments made against flat tax

Some of the arguments against a flat tax system are as follows.

a) The definition of income

Many critics of the flat tax system state that it is hard to define what income is (Absa: 2005). John Kay suggests that “the main reason the tax codes are so complex is that income is inherently a complex concept” (Kay, 2005:11). He suggests that this is the reason for the complexity that exists in our tax system today and that under a flat tax system, the same amount of complexity would need to exist for the system to work.

b) Flat tax would work only in smaller, less developed economies

It has been suggested that a flat tax system would only work in “small, less developed or transitional economies, which have limited capacity to administer complex income tax systems” (Absa, 2005:2). John Kay states in his article in the Business Day that

“the notion that an advanced economy can express the requirements of a fair and robust tax system on a postcard is an impossible dream” (Kay, 2005:11).

It does seem hard to believe that a major corporation could fill out its tax return on a form the size of a postcard, as many flat tax proponents suggest. Many people within America find it hard to believe that in a large and complex economy such as theirs, the simplicity of a flat tax system would work. Scott Hicko is one of these critics, he states that “it is fiction for the Flat Tax Proponents to contend that the Code can be replaced by a simple 20 or 30 page document” (Hicko, 1996: 4).

c) The wealthy would pay less tax

Many people argue that a flat tax system is a tax system for the rich and that the rich would pay a lower amount of tax. This can be seen from statements such as “there is no question that the super wealthy will be the gigantic winners from a Flat Tax system” (Hicko, 1996:31).

d) Job losses

E Davie estimates that there could be in “the region of 40 000 professionals living off the tax laws” within South Africa (Davie, 2004:12). A simplification of the tax laws, as the flat tax proponents suggest, would probably put these people out of a job. This estimated number of people is a fairly large number of economically active taxpayers within South Africa. The effects of these job losses could be far reaching and need to be taken into account.

2.2.2.4 Proponents’ answers to the critics

Pirie has answered many of the objections to the flat tax system that John Kay raises in an article written in response to some of the above opinions. Other flat tax proponents have also mentioned some of the above issues.

a) The definition of income

Pirie states that “for all but a tiny minority, their taxable income would be obvious” (Pirie, 2005:13) as most taxpayers are paid a salary or a wage with perhaps a couple of “easily quantified benefits” (Absa, 2005:2). This would mean that the majority of taxpayers will not need a complicated tax act to determine what their income is. Pirie goes on to state that the reason the current system is so cumbersome is that the tax rates are high, which cause people to seek out loopholes to exploit (Pirie: 2005).

The Hall-Rabushka proposal suggests that the individual wage tax imposed at a flat rate would tax only wages, salaries and pensions. The business tax they suggest would tax all the other components of income. This would, in their opinion, “form an airtight tax system” (Hall and Rabushka, 1985:46). They also suggest that capital gains would be included in the business tax. This would mean that the distinction between capital and revenue would no longer hold the same importance as it does currently in many countries with graduated tax systems and Capital Gains tax. This would drastically simplify the definition of income.

b) Flat tax would work only in smaller, less developed economies

The proponents of flat tax state that the answer to this criticism can be seen in the countries that have implemented a flat tax system. They state that “Hong Kong is by no means a less developed economy and Russia is not a small one” (Pirie, 2005:13). By examining the countries that have implemented flat tax systems and have produced good results (for whatever reason), one can see that these systems appear to have worked to some degree even if the growth cannot be attributed directly to a flat tax system.

c) The wealthy would pay less tax

It has been suggested that due to both the incentives and opportunities the wealthy have to avoid tax, “experience suggests, that the rich usually pay about as much tax under a flat tax regime as they do under an orthodox code” (The Economist, 2005c:9). This would mean that the wealthy would not pay less tax under a flat tax regime.

d) Job losses

E Davie suggests that “introducing a simple flat tax would allow these highly skilled people to do something more productive” (Davie, 2004:12). This could possibly be true, but the immediate repercussions of the loss of jobs could be far reaching and not necessarily all these professionals are in a position to learn a new trade. This factor would have to be weighed up against the proponent’s claim that a flat tax system would help job creation and raise the level of collections. The loss of jobs would also mean that these people would pay less tax. The affect of this would also have to be taken into account.

e) Vested interests in the tax system

E Davie suggests that objections to the flat tax system will come from those who have a vested interest in the current taxation system. These are:

- “Taxpayers who currently receive special privileges that reduce their taxes below the low flat rate.
- Tax lawyers, accountants and other professionals that earn high incomes from the complexity of the existing system.
- Tax experts hired by the state to deal with the current complexity and track down tax evaders” (Davie, 2004:12).

E Davie equates the hiring of tax professionals to investigate tax reform to “asking wolves to look after the sheep” (Davie, 2004:12).

2.3 Economic freedom and its role in tax

It has been suggested that a free economy is the best type of economy to promote growth and welfare for a country. The flat tax system is said to promote a free economy and it has been suggested that this would promote growth in the economy. The general aim of South Africa as mentioned in its budget documents is “creating a

more competitive direct tax regime capable of supporting investment and economic growth” (Joffe, 2005:8). This seems to suggest that South Africa needs to investigate the feasibility of a flat tax system.

The following graphs illustrate how increased economic freedom tends to benefit an economy (Gwartney and Lawson, 2004:22):

Exhibit 1.7: Economic Freedom and Economic Growth

Countries with more economic freedom have higher growth rates.

Source: The World Bank, World Development Indicators 2004 (online).

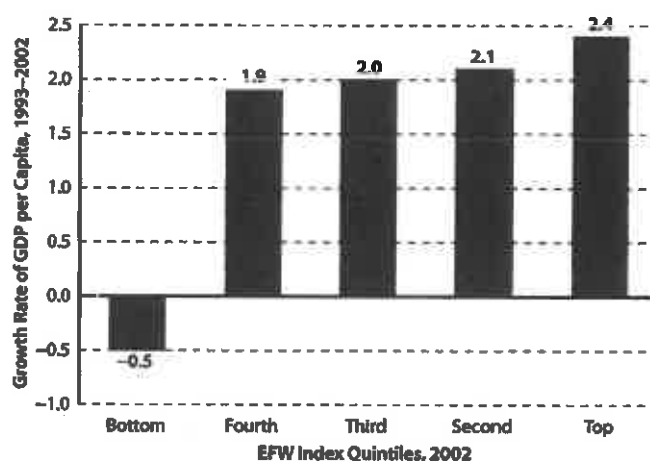
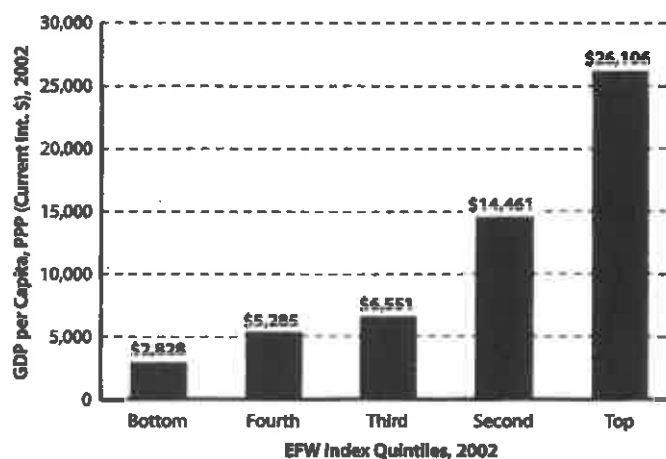


Exhibit 1.6: Economic Freedom and Per-Capita Income

Countries with more economic freedom have substantially higher per capita incomes.

Source: The World Bank, World Development Indicators 2004 (online).



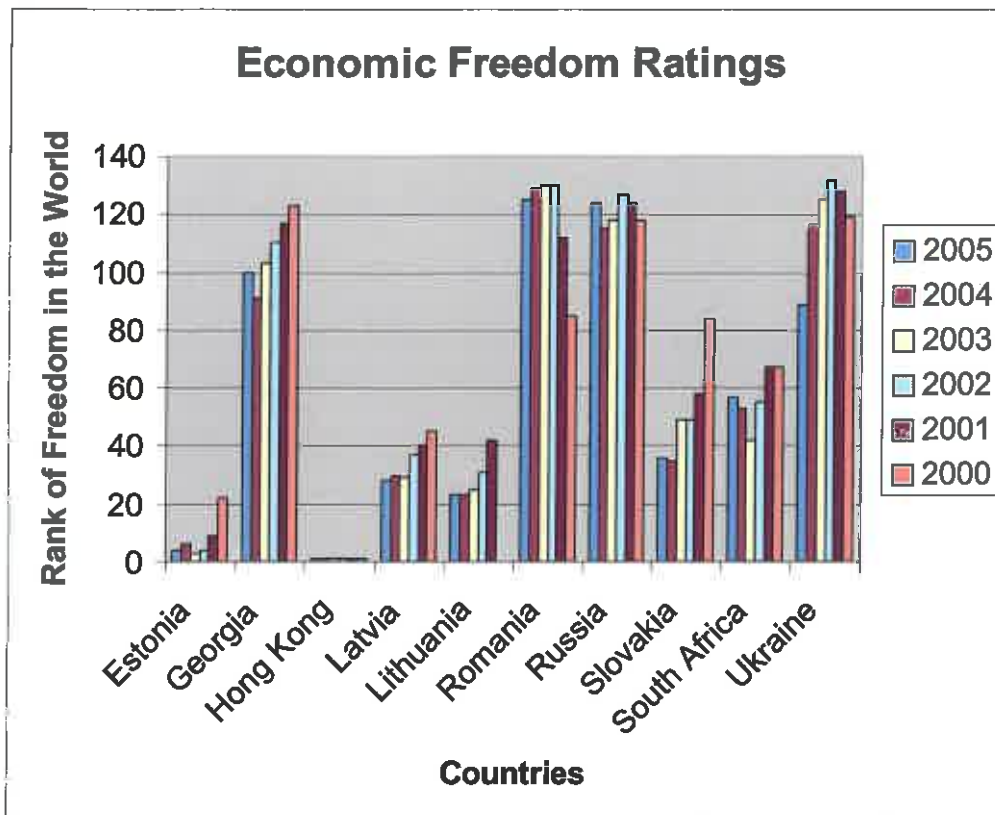
These graphs suggest that the greater the economic freedom, the greater the growth rate of GDP per capita and per capita income (Gwartney and Lawson: 2004). A question that needs to be asked is whether or not a flat tax system could help to attain economic freedom.

The Economic Freedom Index as published by the Heritage Foundation and The Wall Street Journal provides an indication as to where a country stands within the global economy (Miles et al: 2005). This index gives a score (one being free and five being repressed) to each country of the level of economic freedom, by taking into account many different factors that play a role in the economy. This index also ranks countries from the most economically free (one) to the least (over 150) (Miles et al: 2005).

The factors that are taken into consideration to produce this index for a country are: a country's trade policy; the fiscal burden of the government; government intervention in the economy; monetary policy; foreign investment; banking and finance; wages and prices; property rights; regulation and the informal market (Miles et al: 2005). All these factors are given a score and the total score of a country is calculated. Depending on this score, countries are rated from the most economically free to the least.

The following graphs are calculated on the information published in the 2005 Economic Freedom Index (Miles et al: 2005). Past years results were compared to the current year for the period 2000 to 2005. The flat tax countries and South Africa were examined.

The first graph, "Economic Freedom Ratings" shows where each country ranks in the world. Hong Kong is rated as number one. This means that it has been judged to be the most economically free country in the world (Miles et al: 2005). In 2004 and 2005, there were a total of 161 countries that participated in this calculation. In 2000 to 2003, there were 164 countries that participated. It can thus be seen that Georgia, Romania, Russia and Ukraine rank as some of the least economically free countries in the world on the economic freedom index. This means that they do not have a good economic freedom score.

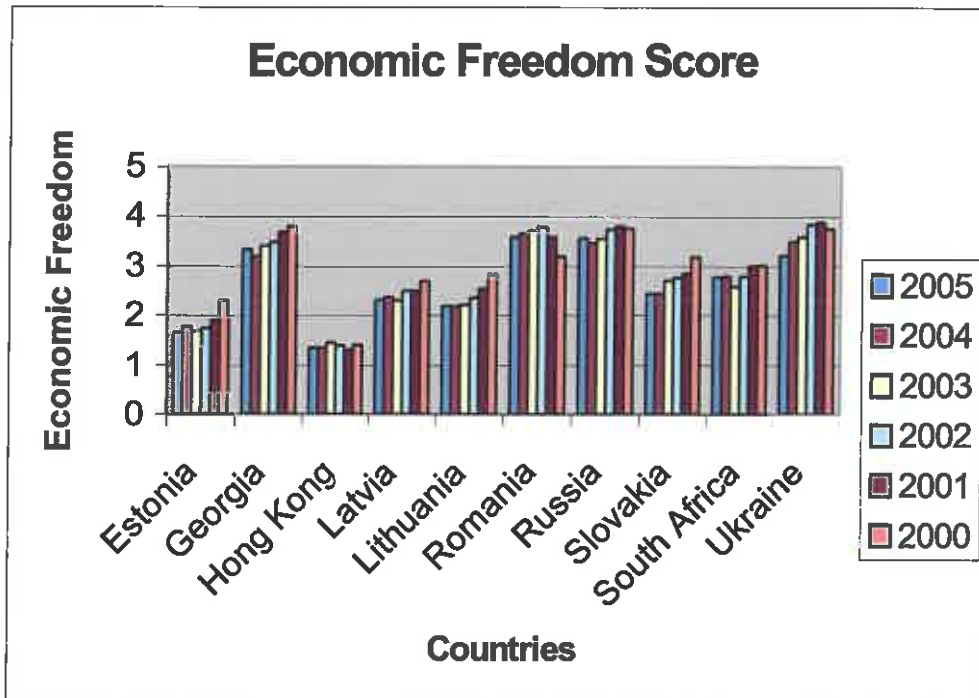


The next graph, “Economic Freedom Score”, shows the actual scores achieved by the flat tax countries and by South Africa from 2000 to 2005. This shows whether a trend exists in countries that have implemented a flat tax system which shows an improvement in their economic freedom score in the following years. There does not seem to be evidence of this in every country that has implemented a flat tax system.

Many countries, however, are starting, for whatever reason, to improve their score of economic freedom. Evidence of this can be seen in Estonia, Georgia, Slovakia and Ukraine. It needs to be determined when these countries adopted a flat tax system and what the change in economic freedom is. Georgia had an increasing amount of economic freedom. However, it only implemented a flat tax system in 2005. This means that there are other areas in Georgia’s economy that are improving.

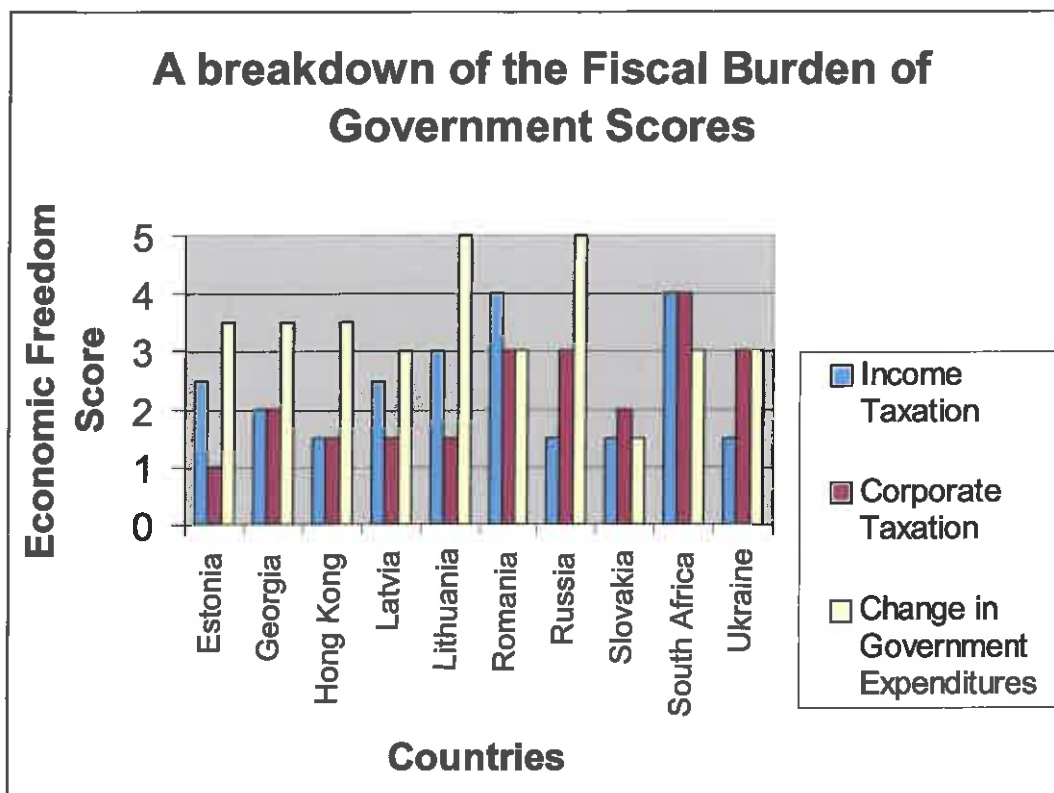
The Economic Freedom score is a score between 1 and 5. The Economic Freedom Categories are as follows (Miles et al: 2005):

- A score of 1 to 1.99 means that a country is economically free.
- A score of 2 to 2.99 means that a country is mostly free.
- A score of 3 to 3.99 means that a country is mostly repressed or 'unfree'.
- A score of 4 to 5 means that a country is repressed.



The tax system within each country was rated from free to 'unfree' and was one of the many factors used in determining the economic freedom of a country as a whole (Miles et al: 2005). The next graph, "A breakdown of the fiscal burden of government scores", illustrates that the economic freedom of a tax system within a country can be seen by breaking down the fiscal burden of government score for each country.

Within the fiscal burden of the government, a score is given to income tax rates, corporate tax rates and to changes in government expenditure (Miles et al: 2005). These three scores were examined between flat tax countries and South Africa in the 2005 period. The lower the rate of tax a country has the better the economic freedom of the taxation system.



This graph shows that South Africa ranks as having the lowest amount of economic freedom in terms of corporate taxes compared to flat tax countries. South Africa's income tax has also been given a high score in comparison with the flat tax countries.

The other factor that is measured in the above graph is the change in government expenditures. This looks at how large the government expenditure is as a percentage of GDP and whether this amount has increased or decreased. A decrease in this amount is seen to promote economic freedom and will give the country a better score (Miles et al: 2005). The countries that have produced the worst scores in this category are Lithuania and Russia.

Government expenditure is another important factor that will influence the economy. A paper that was written on "The size and functions of Government and economic growth" (Gwartney et al: 1998) indicates that "the five fastest-growing economies in the world from 1980 to 1995 had total government expenditures as a percentage of GDP averaging 20.1 percent" (Gwartney et al, 1998:(v)). This is a very low average.

South Africa's current rate of government expenditure is 25.9 percent of GDP in 2005 (Miles et al: 2005). The conclusion of this paper is that a government's "higher spending levels will retard the growth of income"(Gwartney et al, 1998:28) and that "increases in the size of government have slowed economic growth".

2.4 Conclusion

This chapter has documented the views of a number of writers on the advantages and disadvantages of a flat tax system. One of the important reasons given for introducing a flat tax system is that it could promote economic freedom which, in its turn, leads to economic growth. The evidence seems to indicate that a flat tax regime is not sufficient to reduce the economic freedom score, but that other factors within the economy, such as the size and expenditure of government, also play a role. For an increase in economic freedom in the realm of taxation to benefit South Africa, many factors need to be taken into consideration and flat tax may only be one step towards economic freedom and growth.

Chapter Three: a discussion of flat tax countries

3.1 Introduction

The previous chapter discussed the advantages and disadvantages of a flat tax system. The present chapter discusses various aspects relating to countries which have adopted a flat tax, or are considering it. The South African position is also dealt with.

3.2 Flat tax countries

Some of the countries that have implemented flat tax are set out in the following table (The Economist, 2005b:64):

<u>How simple can it be?</u>		
Flat tax rates on personal income		
<u>Country</u>	<u>Rate</u>	<u>Year introduced</u>
Estonia	26	1994
Lithuania	33	1994
Latvia	25	1995
Russia	13	2001
Serbia	14	2003
Ukraine	13	2004
Slovakia	19	2004
Georgia	12	2005
Romania	16	2005

Added to this list are also Hong Kong which introduced flat tax in 1948 (Pirie, 2005:13) and Iraq which introduced a 15 percent rate as from 1 January 2004 (Bartlett: 2003). There are many different types of flat tax systems. Different countries have put different flat tax systems into place.

Another table published by the Cato Institute (Edwards, 2005:1) gives a good indication of both individual and corporate flat tax rates in 2005 in various countries as well as the general tax rates of some other countries.

Top Statutory Income Tax Rates, 2005		
Country	Individual	Corporate
<i>Countries with Individual Flat Taxes</i>		
Estonia	24.0%	24.0%
Georgia	12.0%	20.0%
Latvia	25.0%	15.0%
Lithuania	33.0%	15.0%
Romania	16.0%	16.0%
Russia	13.0%	24.0%
Serbia	14.0%	14.0%
Slovakia	19.0%	19.0%
Ukraine	<u>13.0%</u>	<u>25.0%</u>
Flat tax countries	18.8%	19.1%
<i>Other Countries and Regions</i>		
Czech Republic	32.0%	26.0%
Hong Kong	16.0%	17.5%
Hungary	38.0%	16.0%
Ireland	42.0%	12.5%
Poland	40.0%	19.0%
Singapore	22.0%	20.0%
Europe: 25 countries	40.6%	26.6%
United States	38.6%	39.5%

Many other countries are exploring the possibility of implementing a flat tax system. These include: China (Rabushka: 2004), Norway (Working Party No.2 on Tax Policy and Tax Statistics: 2005), Germany (Lynn:2004), Spain (The Economist: 2005b) and the United States has been debating the issue for years (The Economist: 2005b).

Countries with a flat tax system are discussed in order of their adoption of a flat tax system. Poland is said to be phasing in a flat tax system by 2008.

3.2.1 Hong Kong

According to the 2005 Index of Economic Freedom (Miles et al:2005), Hong Kong is the most economically free country in the world. It also is seen to be one of the largest trading economies in the world, even though it has no natural resources (Emes and Clemens: 2001). This is due to a variety of reasons. According to a quote from The Economist stated by the Fraser Institute, (Emes and Clemens, 2001:53): “The territory’s tradition of simple and low taxes, combined with a comparatively easy-going government . . . is widely seen as a main reason for its stunning rise to prosperity”.

Hong Kong has an unusual taxation system. It has a corporate tax rate of 17.5 percent, but it is the dual individual income tax system that is unusual. The “individual income tax system has graduated rates from 2 to 20 percent” (Edwards, 2005:1) on income that has been adjusted according to deductions and allowances. Alternatively, there is an option to be taxed at a flat rate of 16 percent on gross income, depending on which system calculates the lower liability (Miles et al: 2005).

“However, taxpayers preponderantly choose the flat tax, which offers them lower tax rates, zero preparation costs and a vastly reduced probability of being audited and interrogated by the fiscal authorities” (Grecu, 2004:13).

In the following paragraph, Grecu (2004) explains what other common forms of tax Hong Kong does not institute, how simplicity and low taxation have advantages and that the country has recorded surpluses in the past.

Hong Kong does not have a general income tax, does not tax stock dividends, capital gains, wealth, or gifts, and has no value-added tax, general sales tax, or payroll tax. This combination of simplicity and low level of taxation has reduced the adverse effects of taxation on work effort, saving, and risk-taking and was a key factor in Hong Kong’s remarkable economic growth and development. Notably, the flat tax has generated a high enough level of government revenue such that, between 1950 and 1981, fiscal surpluses have been recorded in no less than 27 years (Grecu, 2004:13).

The Fraser Institute (Emes and Clemens, 2001:54) estimated in a Critical Issues Bulletin in 2001, that due to certain allowances being so high, “70% of the population pay *no* income tax whatsoever; a further 28% of the population pay *below* the 15% flat rate, which, consequently, is paid only by the most affluent 2% of Hong Kong’s residents”. (Note that the flat rate for individuals in 2001 was 15 percent). Greco of the Adam Smith Institute (2004), however contradicts this statement by stating that the majority of taxpayers opt for the flat tax rate.

This unusual form of tax is not the only reason for Hong Kong’s success. There are many factors that play a part in the success of an economy, and a system of taxation is only one of them and may or may not have a large role to play. Another factor that adds to Hong Kong’s success according to certain economists is that Hong Kong also has a “non-interventionist economic policy” that is “constitutionally mandated” (Emes and Clemens, 2001:53). One of the consequences of this is that government spending is not permitted to grow at a rate higher than that of the economy (Emes and Clemens: 2001). This encourages growth within the economy, as there is never more taken out of the economy than is achieved by the economy. This means that the country will not go into debt.

3.2.2 Estonia

In 1994, Estonia implemented a flat tax system, which taxed individuals and corporations at the same rate of 26 percent. In 2000, the country decided “not to tax profits until they are distributed to shareholders as dividends” (The Economist, 2005b:64) thus, “the corporate tax on reinvested profits is 0 percent” (Miles et al, 2005:177). This would increase the incentive for companies to keep their earnings within the company and to reinvest them. Corporate taxes within Estonia do not account for much of the revenue gained and comprise of only 3.6 percent of the total revenues collected in 2003.

This country also has a broad VAT system, which could help to account for the growth seen within the country. The system of VAT raised 9.4 percent of the GDP of

the country in 2002, whereas flat tax contributed 7.2 percent of the GDP in 2002 (The Economist: 2005b).

Estonia's revenues seem to have been rising steadily. The figures presented for number of kroons collected in 2001, 2002 and 2003 according to Matthew Lynn (2004) are 36 billion, 42 billion and 48 billion respectively.

The low rate of tax levied by Estonia has not decreased its tax base (The Economist: 2005b). In fact, this country is planning to cut its flat tax rate of 26 percent to 20 percent by 2007 (The Economist: 2005b) which seems to indicate that the system is working. The current tax rate in 2005 is thus 24 percent. According to Chris Edwards of the Cato Institute, "Estonia has become a magnet for foreign investment and has enjoyed real annual growth averaging 5.7 percent since 1995" (Edwards, 2005:1).

3.2.3 Lithuania

Lithuania introduced a flat tax system in 1994 when it introduced a flat individual tax rate of 33 percent on "income earned from a primary job", however, "income earned from a secondary job is taxed progressively from 10 percent to 35 percent" (Miles et al, 2005:261). In the current year, Lithuania has approved a decision to cut its top individual income tax rate of 33 percent to 24 percent (Edwards:2005). This further cut seems to indicate that the flat tax system within the country is working.

Lithuania had a flat corporate tax rate of 29 percent prior to 2002. From that year, the corporate flat tax rate was reduced to 15 percent. This rate is the same as the tax on dividends (Edwards: 2005).

3.2.4 Latvia

Latvia has a flat tax of 25 percent on individuals and as of 2004, a corporate flat rate of 15 percent (Edwards: 2005).

3.2.5 Russia

“The most remarkable turnaround in government revenues was recorded in Russia” (The Economist, 2005b:65). The reason offered for the increase in revenues is the reforming of the Russian Tax System. In 2001, Russia introduced a flat tax rate on personal income of 13 percent. A different tax rate was imposed on corporate profits: 35 percent in 2001 (The Economist:2005b). This corporate tax rate has since been reduced to 24 percent (Edwards: 2005). The following table of the past and present Personal Income Tax (PIT) Rate Structure is from an International Monetary Fund Working Paper (Ivanova et al, 2005:6).

Table 1: The PIT Rate Structure Before and After Reform

Before Reform (2000)		After Reform (2001)	
Taxable Income ¹	Marginal Rate	Taxable Income ¹	Marginal Rate
Below 3,168	0	Below 4,800	0
3,168 to 50,000	12	Above 4,800	13
50,000 to 150,000	20		
Above 150,000	30		

Source: Russian Tax Code, Part II.

¹ In Russian rubles.

Russia “almost doubled its tax receipts as a percentage of GDP in 2001” (E Davie, 2004:12). “After adjusting for inflation, personal income tax revenue increased 25,2 percent in 2001, 24.6 percent in 2002 and 15.2 percent in 2003. It is predicted to rise more than 16 percent in 2004” (Lynn, 2004:17). It can thus be seen that Russia has done well since introducing its tax reform. The question that needs to be asked is whether this success can be attributed to the flat tax regime and whether there were other factors involved that helped to cause the drastic change seen in the Russian economy. Did the introduction of a flat tax system directly benefit the country in any way?

According to a paper written by Anna Ivanova, Michael Keen and Alexander Klemm on "The Russian Flat Tax Reform", "there is, in short, no strong evidence that tax reform itself caused the PIT revenue boom" (Ivanova et al, 2005:40) (PIT stands for Personal Income Tax). In order to understand the opinion given in this paper, it is important to understand that the introduction of a flat tax scheme was not the only change made by the Russian government in 2001. It is thus hard to isolate the result of a change to a system of flat tax. The paper concludes that probably about half of the revenue gain made by Russia could be attributed to the reduction in marginal tax rates. This conclusion, however, is subject to a number of limitations.

Some of the other changes to the taxation system that could have played a role in the increased revenues collected by Russia according the paper written on the "Russian Flat Tax Reform" were:

- Changes that were made to the base of the Personal Income Tax (PIT) included eliminating various exclusions and the "introduction of a simplified system of deductions" (Ivanova et al, 2005:7).
- An alteration was made to the "sharing agreement of PIT between federal and regional governments" which would have caused a strengthening in the "collection incentive of regional governments" (Ivanova et al, 2005:7).
- The structure of the social insurance payments was altered substantially (Ivanova et al: 2005).
- There was an increase in the taxation of dividends and "the introduction of a non-refundable credit for underlying CIT paid" (CIT stands for Corporate Income Tax) (Ivanova et al, 2005:7).

Another reason for the boom experienced by the Russian economy could be due to the "surging oil prices" (Lynn, 2004:17).

The paper on "The Russian Flat Tax Reform" (Ivanova et al, 2005:40) goes on to state that no evidence was found that "the rate reduction had any strong incentive effect". It was thus not confirmed that a reduction in the tax rate would cause taxpayers to work

harder due to increased incentives as claimed by many flat tax proponents. A behavioural change was noted, however, namely that there was a “marked increase in tax compliance following the reform” (Ivanova et al, 2005:40). This could be attributed to the introduction of a flat tax system or due to the improvements made in the enforcement of tax or partly due to both. Whatever the reason, it was estimated that before the tax reform “Russians in the two higher tax brackets reported only 52% of their income” (The Economist, 2005b:65). After the reform, the amount reported by these households was said to have improved to 68% (The Economist: 2005b).

“Russia’s system is not a pure flat tax, as it retains some deductions and narrow provisions”; however for whatever reason, “in recent years, the nation’s economy has grown strongly, tax revenues have soared, and tax evasion has fallen.” (Edwards, 2005:2). Rabushka states that “after 3 years under the flat tax, real tax revenues in Russia have risen by 80 percent” (Rabushka: 2004).

Many countries in the world are considering the previously unpopular idea of flat tax because of impressive results, such as these, that have been achieved by some of the countries that have instigated a flat tax (other factors need to be taken into account). According to the experience gained by Russia, The Economist (2005b:65) suggests “that the principle virtue of the flat tax is simplicity”. But whatever the cause of Russia’s success, further study needs to be done within this field in order to gain a clearer understanding of the effects of a flat tax regime.

3.2.6 Serbia

Edwards (2005) states that Serbia has a flat rate of 14 percent for both individuals and corporations.

3.2.7 Iraq

A flat tax rate of 15 percent was introduced into Iraq in 2004 (Bartlett: 2003). This rate applies to both corporate and individual tax (Miles et al:2005).

3.2.8 Ukraine

Ukraine's top tax rate reached up to 90 percent before the introduction of flat tax. This is a staggering proportion of tax before the gradual change to a rate of 13 percent for individuals (The Economist: 2005b). The current corporate tax rate for Ukraine is 25 percent (Edwards: 2005).

3.2.9 Slovakia

Slovakia was the first of the OECD (the Organisation for Economic Co-operation and Development) countries to adopt a flat tax system (Working Party No.2 on Tax Policy and Tax Statistics: 2005). The tax system that Slovakia has put into place is probably the tax system that most closely resembles the proposed model by Hall and Rabushka (The Economist: 2005b). In this system, there is a single rate with a "large basic exemption and few special preferences" (Edwards, 2005:2). This country has introduced a system where the same rate of 19 percent applies to personal income, corporate profits and VAT (The Economist: 2005b). This prevents a previous problem that was encountered, namely where taxpayers were abusing the distinction between wages and personal profits.

The Economist (2005b) suggests that taxpayers within Slovakia, before the implementation of flat tax, were declaring that they were self-employed while continuing to work for a company. This meant that their income would not be taxed as wages but rather as profits. This would mean a lower rate of tax as well as the allowance of a deduction of the cost of their lunch in the form of a business expense.

The VAT rate of Slovakia is at 19 percent, this makes it one of the highest VAT rates in Europe (The Economist: 2005b). It has been suggested that "it may be this high rate of VAT, not the flattening of its other taxes, that sustains the government's revenues in the future" (The Economist, 2005b:64).

How is Slovakia's economy fairing under the flat tax and high VAT regime? According to the Cato Institute, "Slovakia is attracting large investment inflows from Western Europe, and its economy is growing strongly" (Edwards: 2005). The

Economist in 2004 (2004: 102) states that "Slovakia's economy is in good shape, especially when compared with its central European neighbours". The Economist (2005a:34) also states that Slovakia has recently become a member of the European Union (EU) and that it now has "unfettered access to Europe's single market". This has helped Slovakia "spur foreign investment and economic growth, while actually leading to a slight increase in tax revenues"(The Economist: 2005a:34).

3.2.10 Georgia

Georgia has adopted a flat rate of 12 percent for individuals and 20 percent for corporations (Edwards: 2005).

3.2.11 Romania

As of 2005, a flat rate of 16 percent has been imposed on both individuals and corporations within Romania (Edwards: 2005). This country will join the European Union (EU) in 2007, which will give the country access to the European market (The Economist: 2005a). This will put the country in a similar position to Slovakia, which also has a flat tax rate and is a member of the EU.

3.2.12 Poland

Poland is the most recent country to announce that it will adopt a flat tax system, to be phased in over the next three years. By 2008, Poland plans to have a flat tax system in place. The tax rate will be 18 percent for income tax, corporate tax and VAT (Absa: 2005). Poland's past top marginal rate of income tax was 40 percent. Due to Poland's location, it will mean that flat tax will be introduced into the middle of Europe. "Some commentators are predicting that, in time, it will influence Western European tax policies" (Absa, 2005:1).

It remains to be seen as to how this will influence the other European countries. Poland will be the second of the OECD countries to adopt a flat tax system after Slovakia adopted a flat tax in 2004 (Working Party No.2 on Tax Policy and Tax Statistics: 2005). This could have an influence over the other countries that are

members of this organisation. Thirty countries are members of this organisation including countries such as Australia, Canada, France, Germany, Norway, the United Kingdom and the United States of America. Some of these countries are discussing the effects of a flat tax system and are considering the possibility of implementing the system (Working Party No.2 on Tax Policy and Tax Statistics: 2005).

3.3 Other countries that are thinking of reducing their tax rates

Countries that are discussing the option of implementing a flat tax system include:

- Germany (Lynn:2004)
- Norway (Working Party No.2 on Tax Policy and Tax Statistics: 2005)
- China (Pirie: 2005) (Rabushka: 2004)
- Belarus (Edwards: 2005)
- Slovenia (Edwards: 2005)
- Spain (The Economist: 2005b).

Many other countries are thinking of “cutting rates to attract investment, reduce tax evasion, and make tax systems more fair and efficient” (Edwards, 2005:2). These countries are not adopting a flat tax rate, but are simply lowering or have recently lowered their rate of tax (Edwards: 2005): Israel, Greece, The Netherlands, France and Austria.

None of the countries that have adopted a flat tax system seem to have come from a similar tax background to South Africa. This needs to be taken into account when considering the consequences of South Africa adopting a flat tax system. Another factor that needs to be taken into account is the size and expenses of government as this was found to be an important factor in the growth of an economy (Gwartney et al: 1998). There are many other factors that will also have to be considered.

3.4 South Africa and flat tax

During the apartheid era of South Africa's history, the Ciskei developed a flat tax system. The tax rate was set at 12% with a primary exemption of R8000. According to E Davie of the Free Market Foundation (2005), who helped initiate the flat tax system, the system was very successful and the low rate of tax provided benefits for many industries, thus encouraging them to set up their operations in the area. E Davie (2005) suggests that a flat tax system would be beneficial to South Africa and that it should be adopted sooner rather than later.

The National Treasury of South Africa is aware of the many countries that are changing to a flat tax system. They have recently explored the flat tax regime of various countries in a brief internal research paper. Initiating a flat tax system is not a simple task. There are many other factors to consider, besides a flat tax, that could have influenced these countries in a positive manner and thus account for the growth experienced. There are also many economic implications to the introduction of a flat tax system that would have to be gauged before a flat tax could be suggested within South Africa (Matshane: 2005).

The National Treasury does not appear to be planning to emulate the previous communist country's economies, but rather seems to be following countries such as the United Kingdom, Australia and Canada and other developing countries like India, and some of the Latin American countries (Matshane: 2005). They do, however, want to be up to date with the changes in tax that are occurring around the world. The implementation of a flat tax system within South Africa could only occur in the distant future, if at all.

Internal research done by the Tax Policy division of the National Treasury found that, although easy to administer, the flat tax is not suitable for our country with a highly skewed distribution of income as it will most likely hit hard on the middle-income groups. It will also not be able to raise a sufficient amount of revenue, which is raised by the current system, because the rate will have to come down substantially to e.g. about 20% and the minimum threshold will have to be increased

substantially to e.g. about R80 000. So the tax will benefit high-income earners and disadvantage middle-income earners (Matshane:2005).

The continuing performance of the countries that have adopted a flat tax system will have to be closely monitored in the future and other factors that could account for the growth in the economies will have to be taken into consideration.

There are also many factors that are specific to the South African economy that need to be taken into account. These are not necessarily as evident in other economies, especially those who have implemented a flat tax system or are considering it. These factors include the fact that South Africa consists of a combination of people who are wealthy and the majority of the population whose income falls below the current tax bracket. "Because income inequality is extreme, all personal income tax and most revenue is collected from a small proportion of the population" (Aaron and Slemrod: 1999).

Many people view the implementation of a flat tax system as a system that would benefit the rich and take away from the poor and middle income brackets. Thus many people within South Africa "see a need for this progressiveness [of the current system] to be protected" (Absa, 2005:4, own addition). There are also taxes currently imposed within South Africa that are not progressive. Examples of these include Value-Added Tax (VAT), excise duties and taxes on fuel.

South Africa has already adopted a number of specific taxes which have a single rate (Ferreira: 2005). These include "VAT, the skills development levy, donations tax, estate duty, secondary tax on companies, stamp duty, uncertificated securities tax" (Ferreira: 2005). These taxes are not true flat tax schemes as they still contain a number of exemptions and deductions that make the taxes fairly complex. The spirit of the simplification of flat tax is thus lost.

Paul Ferreira (2005) believes that individual tax within South Africa has already taken a couple of steps towards a flat tax system. This is due to certain changes in the Taxation Act that, in the last few years, has brought our Act closer to flat tax than before. He gives two reasons for this statement. First is that South Africa has reduced

the number of brackets for individual income tax from nineteen brackets to six brackets. The second is that the number and type of deductions that can be claimed against employees tax has been reduced (Ferreira: 2005).

Many wealthy South Africans have also sought to protect their incomes and assets due to political uncertainties that have occurred within the country in the past decade or more (Absa: 2005). ABSA suggests that a flat tax rate would help to eliminate this past evasion of tax and would also possibly curb the number of assets and investments that have been made outside of the borders of the country. ABSA also suggests that a “flat tax rate would reduce the propensity to export capital” (Absa, 2005:4). This is but one suggestion as to how a flat tax system would improve the future economy of South Africa.

3.5 Conclusion

This chapter has discussed the experience of countries which have introduced a flat tax system and, at the same time, have achieved economic growth and tax efficiency. While it was made clear that the increase in economic prosperity in these countries could not be directly attributed to the flat tax system, the fact that the flat tax rates have progressively been reduced appears to suggest that flat taxes are working. The chapter also touched briefly on the South African situation, where it was recognised that many factors would have to be taken into account in considering a flat tax system as a whole.

Chapter 4: a summary and further areas of research

4.1 Summary

A flat tax system can take on a number of different forms. This can be seen in the differences in the flat tax systems implemented by different countries. Most flat tax systems, however, have certain elements. These are: a single flat rate of tax; the elimination of specific preferences; no double taxation of saving and investment; territorial taxation; a family-based exemption and a consumption-based tax (Mitchell: 2005a). Flat tax is a consumption-based tax that taxes income once and at a low rate as the income is earned.

The Hall-Rabushka system of flat tax suggests that there should be an integrated flat tax system where individuals and companies are taxed at the same rate. This tax system proposes to tax people on “what they take out of an economy” (Hall and Rabushka, 1985: 40). This system also does not distinguish between capital and revenue as any capital gains would be taxed under the business tax.

Adam Smith’s four maxims of taxation need to be taken into account in examining any system of taxation. These maxims are guidelines as to the best tax system for an economy. In this light, the issues of equity, efficiency and simplicity were briefly dealt with. Simplicity has been suggested to be a big advantage of a flat tax system as this system claims to reduce the number of pages in the tax Act making the laws easier to understand. It also claims to reduce the cost of the administration of a tax system and claims that the same amount of revenue would be collected under the lowered and flattened tax rate.

Proponents of the flat tax system have argued that the flat tax system would provide advantages, which would help it to collect the same, if not more revenue than a current progressive system that has a high tax rate. The advantages that the proponents of the flat tax system claim will exist under the new proposed system are numerous. The following advantages have been discussed:

1. The effect of incentives and the theory of the Laffer curve suggest that somewhere between 0 and 100 percent tax the government will collect an optimal level of tax. Proponents go on to suggest that this is due to the increased “reward of extra effort and risk taking” (Pirie, 2005:13). Many proponents suggest that this increase in incentives will primarily affect the wealthy and cause them to work harder and to thus, in the end, pay more tax.
2. The proponents of a flat tax system state that the decrease in the tax rate will increase incentives within the economy and thus increase the reward for risk-taking. This, they suggest, would cause people to work harder and would reduce the incentives to evade tax.
3. A lowered rate in tax has been known to increase compliance. The risk of being caught when there are high penalties is greater than the reward of avoiding the system. An instance where this was known to occur was in Russia. The introduction of a flat tax system in 2001 has increased revenues partly due to the increase in compliance experienced. This is according to a study done on the Russian tax system. It was found, however, that the introduction of a flat tax system was not the only factor that could have increased the compliance.
4. The simplicity of both the system and the administration thereof has been said to be a big advantage of a flat tax system. A reduction in the cost of administration would also help to increase revenues collected.
5. Proponents of the flat tax system suggest that this system will minimise economic distortions that occur due to taxation systems. They suggest that the tax system of a country influences how the people within the economy behave and that a flat tax system would be the best to minimise the effect of a tax system on the economy. It should not be forgotten that there are many other factors to consider that will influence how people behave within an economy, not just the taxation system.
6. According to proponents of the flat tax system, there are competitive advantages to adopting a flat tax system in that the reduced tax rate will encourage local and international investment.

7. It has also been suggested that the flat tax system helps to promote entrepreneurs within a country. This is due to the simplicity of the system and the reduction in marginal tax rates.
8. A flat tax system is said to broaden the tax base for two main reasons. These are: that the low tax rate will increase compliance and that the increase in the reward will cause a person to take more risks. A broadening of the taxation base of a country would mean that more people are contributing to the tax revenue collected.
9. Due to the promotion of economic activity under the flat tax system in the form of investments, it has been suggested that the flat tax system will increase economic growth.

Some of the criticisms of a flat tax system have been briefly noted. These include the fact that a study on the Russian tax system suggested that there was no evidence of an increase in the incentive to work due to the introduction of a flat tax system. It was found, however, that there was an increase in compliance. Some other criticisms of the flat tax system include: that it is hard to define income; that the system would only work in smaller and less developed economies; that the wealthy would pay less tax and that there would be job losses.

The proponents of the system have given their answers to these issues raised and have further stated that the objections to a flat tax system would generally come from parties benefiting from the current taxation system.

Another topic that was discussed briefly was that of economic freedom and the importance of economic freedom in an economy. The Economic Freedom Index was explained and examined. Different countries results were compared and examined. These countries included many of the flat tax countries and South Africa. It could be clearly seen that a low rate of tax was given a good economic freedom rating. An increase in economic freedom in the area of tax would not necessarily have a great effect on the economic freedom of a country as a whole. This is due to the large

number of different factors that are examined in order to gage the rating of economic freedom.

Countries with flat tax systems in place were briefly examined in order to determine exactly what the tax system in each country involved. The tax systems were examined to determine what the tax rates involved were and if there were any other kinds of tax systems that were put in place with the flat tax system. Examples of this are Estonia and Slovakia who have a VAT system in place combined with a flat tax system. Hong Kong also has an interesting tax system where individuals can chose between a graduated system and a flat tax system, whichever system gives the lower tax liability.

The countries briefly examined were: Lithuania, Latvia, Serbia, Iraq, Ukraine, Georgia and Romania. Other countries were examined in a little more detail. These included: Hong Kong, Estonia, Russia and Slovakia. Countries that are starting to consider flat tax were also mentioned, including Poland who is planning to implement the system by 2008. Many countries are also considering reducing their rate of tax even if they are not considering a flat tax system.

South Africa is aware of the flat tax system that seems to be spreading to many areas of the world. During the apartheid era, the Ciskei developed a flat tax system which, according to E Davie, was very successful. The National Treasury of South Africa believes that there are many economic implications that need to be considered before a flat tax scheme could be adopted within South Africa. A recent study done by the National Treasury suggests that the flat tax system would be easy to implement but that due to South Africa's "highly skewed distribution of income" (Matshane: 2005), the implementation of a flat tax system would impact negatively on middle income earners. This study also suggests that not enough revenue would be collected under a flat tax system (Matshane: 2005).

E Davie of the Free Market Foundation is a proponent of the flat tax system and believes that it will benefit South Africa and that it should be adopted sooner rather than later (Davie: 2005). Paul Ferreira believes that South Africa has already taken a couple of steps towards a flat tax system in lowering the number of brackets and reducing the number of deductions in certain areas of the tax Act.

4.2 Further Research

Much research still needs to be done on the topic of flat tax. The following are some of the ideas gained for further research in the topic.

A critical comparison could be done on the equity, efficiency and simplicity of the different proposed flat tax systems and the current South African tax system.

Hall and Rabushka claim that in their flat tax system, “all income is taxed, but the earnings from saved income are not taxed further” (Hall and Rabushka, 1985:42). This statement could be explored further, especially in light of incentives to invest.

The Hall and Rabushka system of flat tax suggests that capital and revenue should not be distinguished from each other. Any capital gains made would be taxed under the business tax. This would be where “the purchase price would be deducted at the time of purchase, and the sale price would be taxed at the time of the sale” (Hall and Rabushka, 1985:58). The ramifications of this change in tax policy could be investigated further.

The National Treasury, in their internal research, has found that flat tax would “hard hit” the middle-income groups within South Africa (Matshane: 2005). Further studies could possibly be done on the effect of a flat tax system on middle-income groups and could examine the effect of a flat tax system in countries that have already implemented the system.

The only research discovered on whether a flat tax system has benefited a country or not was done in Russia and this study was limited to a few aspects of the economy. There are many other countries to be looked at and the effects of a flat tax system could be analysed while taking other economic factors into account. The question could be asked as to what other factors were present within the economy to explain the growth seen in many flat tax countries.

Further research could be done in the area of examining economic freedom and the effects this has on a country. The implications of a change in the taxation system could also be examined in order to attempt to determine what effect this has on other aspects of the economy and what impact this change has on economic freedom as a whole.

There are many aspects of flat tax that still need to be researched in order to determine the effect the implementation of a flat tax system has upon an economy. There are, however, an increasing number of countries that are considering implementing the system. Time will tell whether this controversial form of taxation has the positive impact the proponents of the system claim it will have.

Bibliography

AARON, H. J. and SLEMROD, J. 1999. **The South African Tax System: A Nation in Microcosm**. [On line]. Available:

<http://www.brookings.edu/views/articles/aaron/19991206.htm> [accessed: 21/11/2005]

ABSA GROUP LIMITED. 2005. Focus article: Flat rate income tax system could benefit South Africa. **Economic Perspective**. Third Quarter. 1 – 4.

BARTLETT, B. 2003. **The flat tax is making a comeback**. [On line]. Available: <http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=1586> [accessed 15/09/2005]

BASHAM, P. et al. 2001. **Critical Issues: Flat Tax: Principles and Issues**. [On line]. Available: <http://www.fraserinstitute.ca/shared/readmore.asp?sNav=pb&id=151> [accessed 25/11/2005]

BLUNDELL, J. 2002. **The Global Tax Cartel Cometh**. [On line]. Available: <http://www.iea.org.uk/record.jsp?type=news&ID=120> [accessed 16/09/2005]

DAVIE, E. 2005. Interview. Director, Free Market Foundation of Southern Africa. 19 July.

DAVIE, E. 2004. SA should adopt a flat tax. **Daily Dispatch**. 23 January:12.

DUNCAN, F. 2005. Would 'flat tax' work in SA?. **Citizen**. 08 March:16.

DUNN, D. 2004. **Flat Tax Fiasco**. [On line]. Available: <http://www.wordwiz72.com/flattax.html> [accessed 26/11/2005]

ECONOMIST, THE, 2004. Emerging-Market Indicators. **The Economist**. 21 February: 102.

ECONOMIST, THE, 2005. Charlemagne: Flat is beautiful. **The Economist**. 5 March:34.

ECONOMIST, THE, 2005. Special Report: Simplifying tax systems: The case for flat tax. **The Economist**. 16 April:63.

ECONOMIST, THE, 2005. The flat-tax revolution. **The Economist**. 16 April:9.

EDWARDS, C. 2005. Catching up to global tax reforms. **Cato Institute: Tax and Budget bulletin**. November: 1-2.

EMES, J. and CLEMENS, J. 2001. Flat Tax: Principles and Issues. **Fraser Institute: Critical Issues Bulletin**. April: 53-55.

FERREIRA, P. **Flat Tax for South Africa?**. 2005. [On line]. Available: http://www.lexafrica.com/a_sndmsg/news_view.asp?I=71418&PG=110 [accessed 20/11/2005]

GRECU, A. 2004. **Flat Tax – The British Case**. London: Adam Smith Institute.

GRUBER, J. and SAEZ, E. 2000. **Higher taxes with lower tax rates**. [On line]. Available: <http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=1103> [accessed 01/12/2005]

GWARTNEY, J. et al. 1998. **The size and functions of government and economic growth**. Unpublished report for the Joint Economic Committee. Washington DC: Joint Economic Committee.

GWARTNEY, J. and LAWSON, R. 2004. **Economic Freedom of the World: 2004 Annual Report: South African Edition**. Johannesburg: The Free Market Foundation.

HALL, R.E. and RABUSHKA, A. 1985. **The Flat Tax**. California: Hoover Institution Press.

HICKO, S. 1996. **The Flat Tax: Why it won't work for America**. Nebraska: Addicus Books Inc.

INVESTOPEDIA.COM. 2005. **Laffer Curve**. [On line]. Available: <http://www.investopedia.com/terms/l/laffercurve.asp> [accessed 26/11/2005]

IVANOVA, A. et al. 2005. **The Russian Flat Tax Reform**. Working Paper for the International Monetary Fund: Fiscal Affairs Department, International Monetary Fund.

JOFFE, H. 2005. Never mind the technicalities of tax, let's hear the philosophy. **Business Day**. 12 April:8.

KAY, J. 2005. Flat tax falls down on income definition. **Business Day**. 09 February:11.

LYNN, M. 2004. Flat approach seems to generate an upward curve. **The Star**. 30 November:17.

MATSHANE, O. 2005. Interview and personal communication. Tax Policy Department, The National Treasury of South Africa. 22 July.

MILES, M.A et al. 2005. **2005 Index of Economic Freedom**. Washington and New York: The Heritage Foundation and The Wall Street Journal.

MITCHELL, D.J. 2005. **A Brief Guide to the Flat Tax**. [On line]. Available: <http://www.heritage.org/Research/Taxes/bg1866.cfm> [accessed 26/11/2005]

MITCHELL, D.J. 2005. **A Flat-Out Case for Tax Reform**. [On line]. Available: <http://www.capmag.com/article.asp?ID=4194> [accessed 16/09/2005]

NESVISKY, M. 2001. **Growth rates of small firms substantially improved by lower taxes.** [On line]. Available:
<http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=1092> [accessed 01/12/2005]

PIRIE, M. 2005. The fiscal paradox that works. **Business Day**. 18 February:13.

RABUSHKA, A. 2004. **Flat tax fills coffers in Russia.** [On line]. Available:
<http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=1742> [accessed 01/12/2005]

ROUBIK, D. year unknown. **Income tax reductions increase economic growth.** [On line]. Available:
<http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=729> [accessed 01/12/2005]

STURGEON, R. year unknown. **The Laffer Curve.** [On line]. Available:
<http://www.vistech.net/users/rsturge/laffercu.html> [accessed 01/12/2005]

WALL STREET JOURNAL (editorial). 2003. **Flat tax takes hold in “new Europe”.** [On line]. Available:
<http://www.freemarketfoundation.com/ShowArticle.asp?ArticleType=Issue&ArticleId=1480> [accessed 01/12/2005]

WEINER, N. year unknown. **Adam Smith’s Recommendations on Tax.** [On line]. Available: <http://www.progress.org/banneker/adam.html> [accessed 16/09/2005]

WORKING PARTY NO.2 ON TAX POLICY ANALYSIS AND TAX STATISTICS. 2005. **Fundamental reform of personal income tax – second issues paper.** Unpublished report for the Committee on Fiscal Affairs. Centre for Tax Policy and Administration, Organisation for Economic Co-operation and Development.

Form 1**Individual Wage Tax****1995**

Your first name and initial (if joint return, also give spouse's name and initial)		Last name	Your social security number
Present home address (number and street including apartment number or rural route)			Spouse's social security number
City, town or post office, state, and ZIP code		Your occupation	
		Spouse's occupation	
1. Wages and salary			1
2. Pension and retirement benefits			2
3. Total compensation (line 1 plus line 2)			3
4. Personal allowance			
(a) <input type="checkbox"/> \$16,500 for married filing jointly			4(a)
(b) <input type="checkbox"/> \$9,500 for single			4(b)
(c) <input type="checkbox"/> \$14,000 for single head of household			4(c)
5. Number of dependents, not including spouse			5
6. Personal allowances for dependent (line 5 multiplied by \$4,500)			6
7. Total personal allowances (line 4 plus line 5)			7
8. Taxable compensation (line 3 less line 7, if positive, otherwise zero)			8
9. Tax (19% of line 8)			9
10. Tax withheld by employer			10
11. Tax due (line 9 less line 10, if positive)			11
12. Refund due (line 10 less line 9, if positive)			12

Form 2**Business Tax****1995**

Business name		Employer identification number
Street address		County
City, state, and ZIP code		Principal product
1. Gross revenue from sales		1
2. Allowable costs		
(a) Purchases of goods, services, and materials		2(a)
(b) Wages, salaries, and pensions		2(b)
(c) Purchases of capital equipment, structures and land		2(c)
3. Total allowable costs (sum of lines 2(a), 2(b), 2(c))		3
4. Taxable income (line 1 less line 3)		4
5. Tax (19% of line 4)		5
6. Carry-forward from 1994		6
7. Interest on carry-forward (6% of line 6)		7
8. Carry-forward into 1995 (line 6 plus line 7)		8
9. Tax due (line 5 less line 8, if positive)		9
10. Carry-forward to 1996 (line 8 less line 5, if positive)		10



FREE MARKET FOUNDATION

Johannesburg

PO Box 4056 | Cramerview 2060

Tel 011 884 0270 | Fax 011 884 5672

Email fmf@mweb.co.za

Cape Town

PO Box 805 | Cape Town 8000

Tel 082 941 5375

Email tembanolutshungu@fmfsa.org

Durban

PO Box 17156 | Congella 4013

Tel 031 572 3308 | Fax 031 572 3308

Email jassonurbach@fmfsa.org

30 September 2015

Comments to the Davis Tax Committee (DTC)

on the

DTC's First Interim Report on Value Added Tax (VAT)

About the Free Market Foundation

The Free Market Foundation is an independent public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Background

The DTC's ad hoc VAT subcommittee in June 2014 called on interested parties to make submissions by July 2014 on VAT as outlined in the DTC's Terms of Reference.¹ Twenty-two submissions were received.²

VAT as outlined in DTC Terms of Reference

The DTC's Terms of Reference³ say the DTC must evaluate the tax system by—

Examining the appropriate mix between direct and indirect taxes;

Assessing sustainability of the VAT-to-GDP tax ratio, the economic and social impact of the tax system, and whether the tax structure can generate sufficient sustainable revenues for government spending priorities;

Examining the impact of the tax system in the promotion of small and medium size businesses, including compliance costs, possible further streamlining of tax administration and simplifying the legislation.

The DTC has to consider—

VAT treatment of financial services and VAT apportionment in the financial sector;

VAT efficiency and equity, and advisability of dual rates, zero rating and exemptions;

The impact of e-commerce on VAT revenues; and

Progressivity of the tax system.

The DTC is obliged to take into account the tax system's objectives, including—

Revenue-raising to fund government expenditure; and

Building a cohesive and inclusive society through a progressive tax system and raising revenue to redistribute resources.

¹ The Davis Tax Committee Calls For Submissions, Media Statement, 3 June 2014.

² DTC First Interim Report on VAT to the Minister of Finance, December 2014, pp 5, 40.

³ DTC, About Us – Our Terms of Reference (TOR), 2013.

DTC First Interim Report on VAT

The DTC submitted its First Interim Report on VAT to the Minister in December 2014.

The Minister authorised release of the report for public comment. The Report was made available in July 2015 and comments are invited by the end of September 2015.⁴

Our preference remains Low Flat Income Tax: a progressive consumption tax

Our first preference remains the introduction of a Low Flat Income Tax. (An income tax that is simple, flat and low, with a generous allowance that exempts the poor from paying tax.)^{5 6}

Limiting the burden of taxes on the poor is a central principle of tax reform. The Flat Tax is progressive and thus superior to VAT. A flat rate, applied to all income above a generous personal allowance, provides progressivity and equity.⁷

The Flat Tax, like VAT, is a tax on consumption. While the Flat Tax is a comprehensive income tax (the base is GDP), it is a consumption tax because it removes all investment spending from the tax base. Over time, each act of investment traces back to an act of saving; thus exempting investment from the tax base amounts to exempting saving.⁸

If the Flat Tax is not instituted, alternatives for relieving the poor from the most onerous aspects of the VAT system are justifiable.

VAT a regressive tax

Indirect taxes such as VAT are nearly always regressive, taking a greater proportion of income from the poor than from the rich.

Unsurprisingly, the wealthy tend to spend more money than the poor, but the poor tend to spend all their money, and since most spending goes on items that are subject to VAT or other indirect taxes, a larger proportion of income is taken in indirect taxation from the poor than from the rich. Tax can be the biggest single source of expenditure for those who live in poverty.⁹

Zero-rating

The DTC Report observes¹⁰ that like most VAT jurisdictions South Africa zero-rates some basic foodstuffs, which addresses regressivity to an extent.

But, the Report notes, this approach is not optimally efficient economically. The concession is of greater benefit to affluent households. Zero-rating is thus an inferior way to achieve equity. Theoretically it

⁴ DTC, Release of Davis Tax Committee First Interim Report on VAT for Public Comment, Media Statement, 7 July 2015.

⁵ Free Market Foundation, Submission to the Davis Tax Committee, January 2014, pp 7-11, "Hall and Rabushka Flat Tax System".

⁶ Free Market Foundation, Comments to DTC on First Interim Report on Macro Analysis, August 2015, pp 2-3 "Minimise distortion, broaden tax base, a low tax rate", pp 3-4 "Tax equity, fairness and progressivity", pp 4-5 "Redistribution on the expenditure side".

⁷ Robert E. Hall, Alvin Rabushka, *The Flat Tax*, 2d ed, 2007, pp 78, 81.

⁸ Robert E. Hall, Alvin Rabushka, *The Flat Tax*, 2d ed, 2007, pp 62-63.

⁹ Institute of Economic Affairs, "Aggressively Regressive," IEA Current Controversies Paper No. 47, C. Snowden, October 2013, pp 8-9, 45.

¹⁰ DTC First Interim Report on VAT, pp 7-8.

must be better to collect the revenue and redistribute it by targeted transfers to the poor on the expenditure side of the budget.¹¹

However, the DTC considers that it would be difficult to eliminate current zero-ratings. At best, items could be retained that benefit poor households, such as maize meal, brown bread, rice and vegetables; and items consumed by the affluent could be withdrawn, such as fruit and milk,¹² and possibly (the figures suggest) vegetables and eggs.¹³

The DTC's strong recommendation is that no further *food* items be considered for zero-rating.¹⁴

We reiterate our proposal that the government consider including *essential medicines* in its list of zero-rated VAT products. Taxes on medicines are highly regressive and severely penalise the poorest and most vulnerable members of society.¹⁵

VAT exemption of non-fee-based financial services and resultant VAT cascading

The Report says VAT exemptions are regarded as an aberration from the logic of VAT. Exemptions go against the core principle of VAT as a tax on all consumption, and undermine VAT's efficiency and neutrality. South Africa has a few VAT exemptions, including non-fee-based financial services.¹⁶

The Report observes that (non-fee-based) financial services are exempt because they are considered hard to tax. There may be agreement that supply of financial services to a final consumer should be subject to tax, but determining the consideration for the supply is elusive. Often no explicit charge for the supply is made. Hence most jurisdictions exempt financial transactions and South Africa is no exception, though it imposes VAT on explicit charges.¹⁷

The Report regards the VAT cascading resulting from exempting financial services as an important area that needs addressing. VAT cascading arises because a financial institution providing exempt financial services is denied input tax relief for VAT borne by it on the acquisition of goods and services from third parties. VAT levied by a supplier to the financial institution becomes a hidden cost because it cannot be deducted by the financial institution.

To the extent that the financial services are supplied to businesses who themselves would have been entitled to input tax relief had the financial institution on-charged the VAT paid by the financial institution, the VAT paid by the financial institution becomes a cost. This cost will usually be absorbed in the price charged by the business to its customers – which in turn will attract VAT resulting in tax cascading.¹⁸

¹¹ DTC First Interim Report on VAT, p 21.

¹² DTC First Interim Report on VAT, pp 8, 24.

¹³ DTC First Interim Report on VAT, p 25 Table 3.

¹⁴ DTC First Interim Report on VAT, pp 8, 26.

¹⁵ Free Market Foundation, [first] VAT Submission to the Davis Tax Committee, March 2014. See also *BDLive*, 15 July 2015, Letter: "Merits of a flat tax rate overlooked," Jasson Urbach (economist, director of Free Market Foundation).

¹⁶ DTC First Interim Report on VAT, p 8.

¹⁷ DTC First Interim Report on VAT, p 30.

¹⁸ DTC First Interim Report on VAT, pp 8-9, 30, 47.

The Report contains an Annexure¹⁹ assessing the merits of different foreign jurisdictions' methods of addressing VAT cascading (New Zealand's zero rating of financial services supplied to vendors; Singapore's treatment of exempt supplies to taxable persons as taxable supplies; Australia's reduced input tax credit (RITC) scheme; the European Union member states' option to tax; Quebec's former zero rating of financial services).²⁰

The Annexure recommends that consideration be given to allowing financial-services organisations to claim a reduced input-tax deduction at a fixed rate on certain inputs, similar to Australia's RITC scheme. The RITC scheme allows suppliers of financial services to claim a percentage of the tax paid on specified inputs.²¹ Although a fixed input-tax deduction may not accurately reflect the value added by all financial-services organisations, it eliminates the cascading effect of VAT, and is simple to implement, control and administer; and all financial-services organisations are treated equally.²²

But the DTC does not fully embrace the Australian model recommended in the Report's Annexure, and the Report says only that the DTC, after considering approaches in other jurisdictions to mitigate VAT cascading in the financial-services sector, is of the view that they should receive further urgent consideration by the National Treasury and SARS.²³

We strongly support the adopting of the Australian or another suitable method of mitigating VAT cascading in the financial-services sector. The hidden costs caused by exempting financial services from VAT add to the costs of businesses, particularly small and medium size businesses, and other users of credit and financial services.

Raising the VAT rate

The Report says the DTC is cognisant of the fact that the fiscus may need to generate additional tax revenue at some point in the future. For example, if National Health Insurance is to become a reality, the tax-to-GDP ratio will need to rise significantly. To this end, the Committee requested the National Treasury to undertake a modelling exercise to investigate the impact of increasing VAT from 14% to 17%. There was no particular rationale for choosing a 3% hike, the example being simply illustrative. For comparison, the DTC asked the Treasury to simulate an increase in personal income tax (PIT) rates and in the headline corporate income tax (CIT) rate, such that each of these taxes individually raised revenue by the same amount as 3% increase in VAT, i.e. to generate an additional R45 billion. The increase in PIT would need to be 6.1% and the increase in CIT would need to be 5.2% to realise the same revenue as a 3% VAT increase.²⁴

The Report notes that an increase in VAT would be inflationary in the short run, since prices of most consumer items would rise overnight. In contrast, an increase in personal or corporate tax rates would have a smaller impact on inflation. A VAT increase would have a negative impact on real GDP and employment particularly in the short term, but the impact would be less severe than that of a rise in PIT or CIT. It was thus clear that from a purely macroeconomic standpoint a VAT increase is less distortionary than an increase in direct taxes.²⁵

¹⁹ DTC First Interim Report on VAT, Annexure B: Financial Services, pp 41-65.

²⁰ DTC First Interim Report on VAT, Annexure B esp pp 47-60.

²¹ DTC First Interim Report on VAT, Annexure B at pp 48-50, 55-56.

²² DTC First Interim Report on VAT, Annexure B at p 60.

²³ DTC First Interim Report on VAT, p 9.

²⁴ DTC First Interim Report on VAT, pp 37-38.

²⁵ DTC First Interim Report on VAT, p 10.

However, a VAT increase would have a greater negative impact on inequality than an increase in PIT or CIT. According to the modelling, inequality (measured as the ratio of the richest decile relative to the poorest four) would rise very slightly in the VAT scenario, but would decline in the PIT and CIT scenarios. This is because primarily high-income households are affected by an increase in direct taxes.

It was thus clear that there is a trade-off between efficiency and equity. Raising VAT will have a negative impact on inequality (albeit a very small one), but will be much more efficient than increasing direct taxes. It was also important to consider the longer term: increases in direct taxes dampen growth, which in turn leads to reductions in tax revenues and constrains the ability of the state to reduce inequality through the expenditure side of the budget.²⁶

The Report concludes that, should it be necessary to increase the standard rate of VAT, it will be important for the fiscal authorities to think carefully about compensatory mechanisms for the poor who will be adversely affected by the increase. A range of measures should be considered, such as increases in social grants or the strengthening of the school nutrition programme.²⁷

The media have concluded that the Report “opens the way for a ‘moderate’ increase in the VAT rate”.²⁸

This prompted the DTC to issue a clarification statement that no explicit recommendations were made to increase the VAT rate and reports to that effect are simply inaccurate.

The clarification statement emphasises that, to the extent that the economic evidence points to VAT being the most effective source of additional revenue, a VAT increase without significant recycling of revenue in favour of poorer people is inherently retrogressive. Hence were government to consider an increase in the VAT rate, then the increase would have to be accompanied by sustainable measures that mitigate the retrogressive effects.²⁹

We, the Free Market Foundation, submit that, although some individuals might find the idea of raising VAT to fund National Health Insurance (NHI) politically palatable, raising VAT is a bad idea as it will disproportionately affect the very people that it is supposedly trying to assist. A poor developing country such as South Africa cannot afford a nationalised system of healthcare given the increasing burden of disease, the small tax base, the antiquated infrastructure within the public health sector, the country’s aging population, the inevitable increase in demand that will result from promised “free” health care, and the inadequate number of medical personnel. Nationalised healthcare will impose an impossible burden on taxpayers.

if we use the Council for Medical Schemes average cost of providing Prescribed Minimum Benefits of R510 per person per month (R6,120 per annum), with a population of about 54 million people, NHI will cost about R330 billion per year. When one considers that total revenue from personal income tax collections is only R311 billion, we get some idea of the futility of this ambitious proposal.

²⁶ DTC First Interim Report on VAT, pp 38-39.

²⁷ DTC First Interim Report on VAT, p 10.

²⁸ *Mail & Guardian*, 30 July 2015, “VAT system changes call for caution,” Ferdie Schneider (BDO South Africa national head of tax). See also *Moneyweb*, 13 July 2015, “The Davis Committee’s VAT report unpacked,” Amanda Visser.

²⁹ DTC, Media Statement: Clarification of Points in the First Interim Report on VAT, 17 August 2015.

The government does not have to provide “free health care to all” and finance the healthcare needs of the entire population – this is a disastrous use of scarce taxpayer resources. Additional spending in any one area of the economy necessarily comes at the expense of spending in another. The more government spends on healthcare, the less it will have available to spend providing other critical services such as education, water and electricity.

When it comes to health care, government should concentrate its efforts and scarce taxpayer resources on the poor. For these individuals, government could act as financier but let them decide for themselves where to spend their money – and for those who can afford health care, leave them alone to seek out the cover that would suit them best.

An increase in VAT will not only retard economic growth and exacerbate South Africa’s chronic unemployment problem but will also raise inflation and increase inequality – precisely the opposite of what is required to help the poor.³⁰

The size of government measured by the levels of government consumption expenditure, transfers and subsidies, government enterprises and investment as a share of total investment, which are determinants of taxation levels, have a significant influence on economic activity. Excessive levels of government involvement in the economy and takings in taxes from the productive sector have a dampening effect on economic activity.³¹

Gary Moore
Consultant to FMF

The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction and human welfare. As a think-tank the FMF’s fundamental approach to policy questions is consumer-based. Individual consumer choice is placed at the centre of any policy recommendations that the FMF espouses. Consumer satisfaction is generally achieved by an absence of barriers to entry into the provision of goods and services, allowing consumers a choice between the offerings of freely competing providers, and the absence of regulations that impose avoidable costly burdens on the providers of goods and services.

³⁰ Free Market Foundation, “SA just cannot afford ambitious health plan,” 3 August 2015, Jasson Urbach (economist), <http://www.freemarketfoundation.com/article-view/sa-just-cannot-afford-ambitious-health-plan>

³¹ Free Market Foundation, Submission to the Davis Tax Committee, January 2014, Eustace Davie and Jasson Urbach (directors, Free Market Foundation).



FREE MARKET FOUNDATION

Johannesburg

PO Box 4056 | Cramerview 2060

Tel 011 884 0270 | Fax 011 884 5672

Email fmf@mweb.co.za

Cape Town

PO Box 805 | Cape Town 8000

Tel 082 941 5375

Email fmf.ct@mweb.co.za

Durban

PO Box 17156 | Congella 4013

Tel/Fax 031 572 3308

Email urbach@telkomsa.net

Submission to the Davis Tax Committee

SMALL BUSINESS

The impact of the tax system in the promotion of small and medium size businesses

Note: We attach the Free Market Foundation's submission on the taxation of small businesses. These proposals differ considerably from our proposals on the implementation of a Flat Tax in South Africa. In making such a submission we are not contradicting ourselves. Our first preference remains for income tax to be simple, flat and low, with generous allowances that exempt the poor from paying tax. This submission is made as a second best option. If the Flat Tax is not instituted, we propose alternatives for relieving the poor and small business from the most onerous aspects of income tax.

The Davis Tax Committee's top priority is to facilitate the growth of Small Businesses

Following the Minister of Finance's 2013 Budget announcement, the Davis Tax Committee is examining the role of South Africa's tax system to promote growth, job creation, sustainable development and fiscal self-reliance.

It is gratifying that the top priority of the Committee is to address ways in which the tax system can be improved to facilitate entrepreneurship and the growth of Small Businesses.¹

We are pleased that the Committee intends to review the various tax packages that exist to encourage Small Businesses to find an optimal tax package that assists Small Businesses in contributing towards economic growth and reducing the high unemployment rate.²

The Committee's Terms of Reference say that aspects to receive specific attention include:

Examination of the overall tax base and burden with evaluation of the economic and social impact of the tax system.³

Analysis of the impact of the tax system in the promotion of Small and Medium Size Businesses, including compliance costs and the possibilities for further streamlining of administration and simplification of legislation.⁴

Review of the corporate tax system with special reference, among other things, to tax incentives to promote developmental objectives.⁵

The Committee is also mandated to study tax issues which in its view should be addressed to promote inclusive economic growth, employment creation, development and fiscal sustainability.⁶

Our recommendations in 1999

In 1999 the Free Market Foundation compiled a published series of booklets concerning *Laws Affecting Small Business*, among which was a volume about Tax.⁷ In the introduction to that booklet we said:⁸

'The single biggest problem for most small businesses is lack of capital. Most entrepreneurs use their own savings or retrenchment packages to start up in businesses, sometimes supplemented by personal loans from family members and friends. They run into financial difficulties as soon as their businesses start to grow – having exhausted their personal savings, they find they have no access to loan capital to exploit growth opportunities.

'Very few young entrepreneurs and, because of past apartheid laws, very few black entrepreneurs of any age, have mortgageable title deeds to property. Nor, at the beginning of their business ventures, have they been able to build up significant investment portfolios. Thus they are unable to put up the security required by banks and other lending institutions, which are in any case reluctant to lend to small firms. And there is as yet no significant venture capital market where entrepreneurs could obtain equity capital from outside, independent investors.

'Small firm owners are therefore forced to rely on the cash flow generated from their own profits to finance their firms' growth. Even when profits are good, cash flow is frequently squeezed by the need to carry more stocks and to invest in additional equipment to support greater sales

volumes. The high inflation rates of recent years meant that more cash was required for new stock than was spent on the stock previously sold. The liquidity problems are compounded when, as is often the case, suppliers will sell only for cash and customers will buy only on credit. To complete this dismal scenario, the tax laws of the country require that a large proportion of any profits made, be paid to the state regardless of the devastation this may cause to the small firms' cash position.

'Tax is one of the greatest inhibitors of small business development. The high level of taxes, the enormous volume and complexity of the tax laws, and the administrative sophistication required to comply with these laws are daunting even for well-educated entrepreneurs. For those who through no fault of their own were educationally deprived, it would be easier to climb Mount Everest without oxygen than to understand and comply with all tax laws. There is an urgent need for simplification and preferably also for a reduction in tax rates.

'That great and well-proven engine for wealth and job creation, the small firms' sector, will continue to splutter and choke until there is serious tax reform. Economic growth will be curtailed, unemployment will continue to rise, and social instability will worsen.'

In that booklet we made the following Recommendations relating to the small firms sector:

- Adopt simplified income tax measures within the next two years to govern the taxation of the first part of any taxpayer's income (say, commencing with R100 000 and adjusted automatically for inflation every year).
- Allow small firms to deduct the cost of capital equipment from their taxable incomes in the year in which the cost is paid.
- Allow small firms to deduct a debtors allowance from their taxable incomes which is equivalent to the accrued profits on unpaid sales.
- Grant small firms a tax deduction in respect of profits retained in the business and not withdrawn.
- Increase to R500 000 the value of 'taxable supplies' at which registration for VAT becomes compulsory.
- Increase the threshold beyond which the payments basis for accounting for VAT is not permitted from the present R2 500 000 per year to R5 000 000, and extend this concession to close corporations and companies.
- Accept invoices from exempt small firms, listed with the SARS, as VAT invoices when received by VAT-registered larger firms.
- Provide for automatic inflation-adjustment of all figures embedded in tax legislation that fix exemptions and levels of income, turnovers, assets and other measures that determine liability for compliance with particular elements of that legislation.

There have been some reforms, but further improvements can be made

The Foundation is gratified that a number of our Recommendations in 1999 have been adopted, if only in part.

In this submission we reiterate our Recommendations which have not been adopted (with their supporting arguments updated for current circumstances). These Recommendations are:

- Adopt simplified income tax measures within the next two years to govern the taxation of the first part of any taxpayer's income (say, commencing with R215 000⁹ and adjusted for inflation every year).
- Allow small firms to deduct a debtors allowance from their taxable incomes which is equivalent to the accrued profits on unpaid sales.
- Grant small firms a tax deduction in respect of profits retained in the business and not withdrawn.

(We also highlight, later in this submission, the merits and demerits of legislative changes introduced concerning Small Business Corporations, Micro Businesses, VAT returns and venture-capital deductions, followed by an analysis of how these various changes have been adjusted over the years, and their scope and effect.)

RECOMMENDATIONS

Adopt simplified income tax measures to govern taxation of the first part of any taxpayer's income¹⁰

A new simplified income tax act should be prepared and introduced within the next two years to govern the taxation of, say, the first R215 000 of any taxpayer's taxable income. (The existing Act can be left in place to deal with those portions of incomes that exceed R215 000, though even here simplification will be highly desirable.)

It is unjust to have laws of such complexity that they are inaccessible to citizens whose lives and livelihoods are profoundly affected. It should be possible to have a brief, simple and straightforward set of laws applicable to taxpayers earning less than a specified income. The objective should be to have laws that can be easily understood by those to whom they apply.

Individuals with taxable income above R215 000 could remain subject to the existing laws in respect of income above that amount, or alternatively continue to be taxed under the existing laws.

The simplified income tax laws should be stripped down to the bare essentials. This would mean determining in the simplest possible manner how to calculate taxable income and tax payable. Any taxpayer wishing to claim an expense that falls outside the ambit of these laws could have the option of choosing to be taxed under the existing laws.

Simplified tax laws, if they were to be accompanied by simple procedures and requirements, would save taxpayers huge amounts in administrative costs, professional fees and other compliance costs. They would also relieve the South African Revenue Service of a considerable part of its administrative burden.

Recent measures allowing Micro Businesses to apply to pay turnover tax instead of income tax do not properly address this issue (see below).

The case for simplifying tax laws and regulations¹¹

Tax laws are so complicated and voluminous that almost all members of the public, even those reasonably literate and numerate, are baffled by them. A result of the complexity and volume of tax laws and their high tax rates is the ever-increasing size of the thriving tax-advice industry –lawyers, accountants, life assurance brokers and financial advisers.

Small business owners who cannot handle their tax matters themselves nor afford to hire these expert services to handle them on their behalf, have no choice but to operate in the so-called informal sector. It is not a glamorous or pleasant place to be. Most people prefer to be on the right side of the law whenever possible and provided the laws accord with the communities' sense of justice. When it is not possible, as it is not for many small-firm operators, confinement to the informal sector prevents growth, visibility and security. Only the alternative of unemployment and destitution is worse.

It should not be thought that those who are forced to operate their businesses in this way pay no taxes. They pay plenty in terms of VAT (unrecoverable by them), in terms of the passed-on effects of corporate income taxes in the prices they pay for goods and services they purchase from large suppliers, and in terms of customs and excise duties, especially perhaps those included in petrol prices. Many of them too, although legally required to register and submit returns, would fall below the existing tax thresholds. It does not seem sensible to require registration and returns, let alone taxes, from those whose incomes do not provide them with any decent standard of living anyway. It is also very doubtful whether increasing exemption levels a little would seriously reduce tax collections.

It is generally agreed that a good tax system needs to be characterised by simplicity, certainty, neutrality, and a low cost of administration and collection. The present South African system falls short of all these ideals. It cannot be regarded as either simple or certain when it is not understood by more than 90% of the population; it is not neutral when compliance costs for small firms can be ten times the proportionate costs of big corporations; and although the administration and collection costs incurred by the SARS may be quite low, the huge size of the tax advice industry indicates that the overall costs are extremely high.

What to do? In this modern age of big governments and high taxes it seems unrealistic to imagine that wealthy countries can have simple tax systems. High taxes cause wealthy people to spend time and money on avoidance schemes, and that in turn causes governments to enact complicated anti-avoidance provisions. It is a vicious circle. But the vast majority of South Africa's residents are not at all wealthy by current world standards and many are desperately poor by any standards. Yet as things are, they are burdened with a tax system suitable at best only for the tiny, wealthy minority.

A possible solution would be to introduce a dramatically simplified income tax system applicable to, say, the first R215 000 of all taxpayers' incomes. The existing system would then apply only to those portions of more wealthy taxpayers' incomes that exceed that amount. Such relatively wealthy taxpayers can reasonably be expected to hire the expertise they need to comply. The rest, the vast majority with incomes below the R215 000 level, would not need to concern themselves with the more complicated, higher-level system.

The simplified system should also, among other things:

- Raise tax thresholds well above poverty threshold levels and not require registration or returns from people below these thresholds.

(The National Income Dynamics Study undertaken for the National Planning Commission said in December 2013 that Poverty refers to (2012) monthly household income per capita of less than R636.¹²)

- Significantly reduce the number of tax bands.
- Simplify or even scrap rebates and certain types of deductions.

- Encourage saving.
- Encourage small firms to plough back profits.
- Allow small firms to calculate taxable incomes on a cash, rather than an accrual, basis.

The aim should be to exempt as many as possible from the requirement to submit any returns at all and for the rest to so simplify things that the annual return does not exceed one page in length and the explanatory brochure does not exceed two pages (both to be available in all official languages).

Let us not pretend that it is easy to change tax laws. Unless very carefully considered, changes can often have unanticipated and undesired effects. Obviously, precautions will have to be taken to prevent abuse by income-splitting or other means, but these difficulties can be overcome.

If the effects of the present tax system and the more general structures of the economy were neutral in their impact on businesses regardless of their size, the case for giving any special consideration to small firms would be weakened. In many ways, however, over many years economic structures have been distorted, leaving small firms at a significant competitive disadvantage:

- Laws were made (and still are) on the assumption that all citizens are equally well educated.
- Many laws create barriers to entry into business, so that those on the inside are protected from new competition from those still on the outside.
- Many laws are enacted on the basis that 'one size fits all', i.e. with an implicit assumption that the costs of complying with them will be proportionately similar regardless of the size of the entity concerned. In practice, the compliance costs for small firms can be ten times greater, per unit of sales or per unit of profit, than the comparable costs for their larger competitors.
- Once legal action goes beyond the very limited jurisdiction of the Small Claims courts, justice through court action is largely confined to the wealthier. It is not uncommon for small firms to abandon valid claims against affluent suppliers and customers because of their inability to pay for the necessary legal assistance.
- The small firms sector is poorly organised and has neither the money nor the time to match the sophisticated and continuous lobbying efforts of the corporate world and of organised labour. In many cases the rent-seekers triumph over the interests of small firm owners.

There is therefore a case for offsetting the structural disadvantages imposed on small firms with some countervailing benefits, if equality of opportunity to compete is to be achieved. A restructuring of the tax system is a good place to begin this process.

The case is strengthened by the undoubted economic and social benefits that the nation would derive from having a much stronger small firms sector. This sector, in all the economically successful countries of the world, is the main generator of new, wealth-creating and sustainable jobs. It is also the source of most of the useful inventions and innovations. It is essential if South Africa is to become globally competitive, and it is essential if competitive business opportunities are to be redistributed to those entrepreneurs previously suppressed and disadvantaged.

Allow small firms to deduct a debtors' allowance from their taxable incomes which is equivalent to the accrued profits on unpaid sales¹³

The obligation to pay income tax on amounts not yet received causes hardship for small firms. Debts owing to them usually increase in amount year by year with the result that the total amount of taxes paid on accrued income also steadily increases, draining the capital available to the firm.

In its simplest form, the calculation of the debtors' allowance would consist of applying the average gross profit percentage achieved by the firm on all sales during the year to the amount by which total sales invoiced but not yet paid at year-end have increased relative to the previous year.

The figure resulting from this calculation would be equivalent to the profit on unpaid sales for the tax year. Deducting the figure from the taxable income of the small firm would have the effect of subjecting to income tax only those profits which have actually been received.

(As a rule income tax is payable in respect of taxable income received 'or accrued'.¹⁴)

This is similar to the dispensation granted to natural persons to pay over only VAT received rather than VAT invoiced but not yet received.

(Vendors must generally account for VAT payable on an invoice basis.¹⁵ But the Commissioner can on application direct that a vendor account for VAT payable on a payments basis, if the vendor is a natural person (or unincorporated body of natural persons) the total value of whose taxable supplies in any period of 12 months doesn't or likely won't exceed R2,5 million.¹⁶ (He must still account on an invoice basis for supplies other than fixed property for which the consideration is R100 000 or more.¹⁷)

(Vendors become liable to be registered for VAT when their annual taxable supplies exceed R1 million,¹⁸ but have the option to register if their annual taxable supplies exceed R50 000 or can be expected to exceed it in 12 months.¹⁹ A vendor who has exercised this option and whose taxable supplies are expected to exceed R50 000 in 12 months must account on a payment basis with effect from registration but must do so on an invoice basis as from the tax period after the one in which his taxable supplies exceed R50 000.²⁰)

The principle involved in this recommendation is also recognised in the provision of the Income Tax Act which permits an allowance for certain unpaid receipts on instalment sales.

(As a rule, if a taxpayer has entered into an agreement with another person the effect of which is that ownership of property will pass on or after receipt by the taxpayer of all or a certain portion of the amount payable to the taxpayer under the agreement, then the whole amount is deemed to accrue to the taxpayer on the day the agreement is entered into.²¹

(But if 25% or more of the amount becomes payable only after expiry of a period of at least 12 months after the date of the agreement, the Commissioner can make such allowance as under the special circumstances of the trade seems reasonable in respect of all amounts deemed to accrue under the agreements but not received at the close of the taxpayer's accounting period. The allowance must be included as income in the taxpayer's return for the following year as income.²²)

An alternative to this recommendation would be to tax small firms on taxable income determined entirely on the cash basis. This would mean taking into account only amounts actually received and paid during the tax year.

Grant small firms a tax deduction in respect of profits retained in the business and not withdrawn²³

Shortage of capital tends to be a greater constraint on the growth of small firms, especially in their first years of operation, than on larger firms. Exempting the retained profits of small firms from income tax, or reducing the rate of tax charged on such retained profits, could consequently bring about more rapid growth and create more jobs than the granting of similar relief to large firms.

Small firms would derive great benefit from relatively more substantial tax relief in the early years of their operations. Government should therefore consider granting tax relief on a substantial proportion of the profits earned by small firms in the first (say) seven years of doing business subject to those profits being retained and utilised in the business. Consideration could, for instance, be given to a complete exemption from income tax for profits that have been retained by small firms for a minimum of five years.

Legislation similar to the provision of the Act that deems certain amounts distributed to be dividends²⁴ for purposes of secondary tax on companies²⁵ (abolished as from April 2012²⁶) could be devised to eliminate tax avoidance schemes.

One of the advantages of this recommendation is that the beneficiaries would be self-selecting. No unprofitable businesses would benefit. The fastest-growing small firms making the highest profits would receive the greatest tax relief, giving them more capital to grow even faster.

Implementation of the recommendation would assist in countering the perverse effects on economic growth of the graduated income tax system. As incomes increase, this system takes an increasing percentage in taxes, so it is precisely those small firms that are making the biggest contribution to economic growth that attract the highest taxes.

Critics of this recommendation will maintain that it is unfair to grant small firms a competitive advantage by postponing and possibly even exempting from income tax the profits retained and re-invested by them. This criticism would be valid if all firms were presently competing on level terms, which they are not. Some of the factors currently militating against small firms are:

- In high-tax regimes, small firms have greater difficulty than large firms in increasing their investable funds. Investors expect much lower rates of return from large firms than from small firms and most would never consider investing in small firms because of the greater risk. Small firms consequently have to rely almost exclusively on generating their own capital out of after-tax profits. If there was no income tax, small firms would, on average, grow comparatively much more rapidly than large firms.
- Several factors weigh against the ability of small firms to borrow money to expand their businesses. First, because of the large amounts of money the government borrows, lending to private borrowers is less attractive and considered to be a higher risk than if government was borrowing less or not at all.

- Second, because of the limits the National Credit Act²⁷ places on the rate of interest that can be charged on loans, small firms cannot compensate lenders for risk by paying higher interest rates prescribed under that Act.

(The National Credit Act authorises the Minister responsible for consumer credit matters, after consulting the National Credit Regulator, to prescribe a method for a maximum rate of interest applicable to each subsector of the consumer credit market as determined by the Minister.²⁸ A consumer includes²⁹ a party to whom money is advanced or credit granted under a credit agreement, including³⁰ any agreement whereby payment of an amount owed by one person to another is deferred and any charge, fee or interest is payable to the credit provider in respect of the amount deferred.³¹)

(The Minister has prescribed, as the maximum rate of interest per year for unsecured credit transactions and for 'developmental credit agreements for the development of a small business',³² the ruling Reserve Bank Repurchase Rate multiplied by 2.2 plus 20%.³³

(The National Credit Act applies to every arm's-length credit agreement, except—

An agreement with a consumer who is a juristic person whose asset value or annual turnover exceeds the 'threshold value' determined by the Minister³⁴ (currently R1 million³⁵); and

A 'large agreement' (a credit transaction whose principal debt falls at or above a threshold for large agreements established by the Minister,³⁶ currently R250 000³⁷) with a consumer who is a juristic person with an asset value or annual turnover below the determined threshold value³⁸ (R1 million as aforesaid³⁹).

- Finally, small loans are unattractive to lenders as the administrative costs of making such loans are proportionately much higher than the costs of making large loans.

Government should evaluate the potential economic growth and demand for labour that could emanate from the small business sector if it were allowed to accumulate capital from the re-investment of retained profits.

SMALL BUSINESS CORPORATIONS, MICRO BUSINESSES, VAT RETURNS AND VENTURE-CAPITAL DEDUCTIONS

Merits and demerits of legislation

Small Business Corporations

Small Business Corporations, whose gross income initially could not exceed R1 million, (a ceiling since increased and now R20 million) now pay lower than normal income taxes, according to a graduated rate structure. (A drafting error in the 2013 amendment, that the increase in their gross-income ceiling from R14 million to R20 million would apply for only one year, needs rectifying.)

SARS reported in 2013 that of the 600 000 companies assessed in 2011 only 100 000 were assessed as Small Business Corporations. This seems unduly low, and more effort should be made to promote the

dispensation. The restrictions that disqualify certain types of businesses and owners from benefiting from the tax should be relaxed as far as possible.

Our recommendation that small firms should be allowed to deduct the cost of capital equipment from their taxable incomes in the year in which the cost is paid has been partly adopted. Since 2001 Small Business Corporations can immediately deduct investment expenditure in manufacturing assets in the year in which the investment is made. This should be extended to non-manufacturing assets. (Since 2005 Small Business Corporations are eligible over three years for a 50:30:20 deduction for non-manufacturing assets.)

The Minister of Finance in his 2014 Budget Speech said that consideration is being given to replacing the graduated tax structure for Small Business Corporations with a refundable tax compliance credit.⁴⁰ More particulars are required to enable interested parties to comment constructively.

Micro Businesses

Since 2008 Micro Businesses (businesses with a turnover less than R1 million a year) can apply for registration to pay turnover tax as an alternative to income tax.

It is pleasing that registered Micro Businesses can elect to pay employees' tax ('PAYE'), skills development levies, and unemployment insurance contributions only twice a year instead of monthly.

It seems very few Micro Businesses have registered for turnover tax. Registered Micro Businesses have to pay turnover tax whether or not they made a profit, whereas they would not pay normal income tax if they made a loss. Once registered for turnover tax, a Micro Business cannot be deregistered for three years. These weaknesses should be addressed.

The Minister in his 2014 Budget Speech said the turnover tax regime will be amended to further reduce the tax burden on micro-enterprises.⁴¹ It is trusted that the new measures will be sufficiently far-reaching.

We approve the increase in 2009 in the value of 'taxable supplies' at which registration for VAT becomes compulsory to R1 million.

VAT returns

We approve the arrangement that VAT vendors with annual taxable supplies of up to R1,5 million can file VAT returns every four months instead of monthly, and the arrangement introduced in 2012 as from March 2014 that registered Micro Businesses can apply to file VAT returns every six months.

Venture capital deductions

The interesting innovation introduced in 2008 allowing the deduction of expenditure to acquire shares in venture-capital companies is promising but needs streamlining.

The Minister in his 2014 Budget Speech announced that amendments will be made to the venture capital company tax regime.⁴² It is hoped that the amendments will address the following shortcomings:

The criteria needed to qualify for the incentive are too onerous to attract many venture capitalists.

Investors are not given the choice to invest directly in startups, but have to do so via a venture-capital company. The fact that a deduction is recouped if on disposal of shares in a venture capital company might put investors off, because the full amount of an investor's deduction would be recouped in one year and capital gains tax applied to any profits made from selling the shares. The recoupment rule has been as a key reason why funds are unable to raise sufficient money from investors.

Investors might also be put off by the high penalties. SARS can levy 125% of the amount contributed by an investor if it withdraws the status of a venture capital company.

Venture capital companies also have to be vetted by SARS and licensed by the FSB, which can take time.

There is no good reason for all these prior requirements. If objective rules are set that venture-capital companies can comply with, they should not be subject to special vetting or required to be licensed before the tax benefits apply. Venture- capital investment should not be made more onerous than compliance with any other tax rules. The purpose should be to attract venture-capital investment in small firms, not to deter it.

Analysis of Legislative Changes

Small business corporations

The Income Tax Act says that companies, including close corporations⁴³ and associations registered as co-operatives,⁴⁴ must pay income tax annually in respect of their taxable income each financial year.⁴⁵ The rates of tax chargeable are fixed annually by Parliament.⁴⁶

Small Business Corporations pay lower rates of tax than regular companies, increasing in brackets to the rate payable by regular companies.

A Small Business Corporation is (very succinctly⁴⁷):

A private company, close corporation or co-operative, the gross income of which for the year does not exceed R20 million, the shareholders of which are natural persons who do not have stakes in other businesses, that does not derive more than 20% of its revenue from investments and the rendering of personal services, and that is not a personal service provider unless employing three or more people.

Provision for Small Business Corporations was first made in the Income Tax Act in 2000. It stated that a Small Business Corporation was a private company etc. whose gross income for the year did not exceed 'R1 million'.⁴⁸

The initial R1 million ceiling in 2000 was increased from time to time by Amendment Acts: to R3 million in 2002,⁴⁹ to R5 million in 2003,⁵⁰ to R6 million in 2005,⁵¹ to R14 million in 2006,⁵² and then to R20 million in 2013.⁵³

Some (but not all) of these Amendment Acts say that the amendments to increase the ceiling applies to any year of assessment which ends on 'or after' a specified date.⁵⁴ This means that the amendments

apply to all future years of assessment until future amendment. (Strictly speaking it is unnecessary for the statute to say so. Statutes by their very nature legislate for the future.⁵⁵)

Unusually, however, the 2013 Amendment Act says only that the amendment increasing the ceiling from R14 million to R20 million applies in respect of years of assessment ending during the period of 12 months ending 'on 31 March 2014'.⁵⁶

This means that the increased ceiling of R20 million will apply only until 31 March 2014. It follows that the increase of the ceiling to R20 million will lapse on 31 March 2014 and the ceiling will revert to R14 million.

This is obviously a drafting error that should be remedied, unless any 2014 Amendment Act is passed that further increases the ceiling above R20 million.

Reduced graduated tax-rate structure for Small Business Corporations

A graduated tax-rate structure for Small Business Corporations was first introduced in 2000.

The Minister of Finance said in his Budget Speech that year:⁵⁷

'The development of small and medium size enterprises is fundamentally important to the growth and employment potential of our economy. To complement a number of existing government initiatives directed at SMEs we propose to introduce a graduated company tax rate structure for incorporated small and medium size enterprises. Qualifying small corporations will pay 15% on the first R100 000 of taxable income and [the normal company rate] thereafter.'

This graduated tax-rate structure for Small Business Corporations was duly enacted in 2000.⁵⁸

The tax rates or tax brackets, or both, for Small Business Corporations have been adjusted over the years:

The introductory rates in 2000 for Small Business Corporations were set in two brackets: 15% of the amount of taxable income up to R100 000 and 30% of the amount of taxable income over R100 000.⁵⁹ This 30% rate was the same as the 30% tax rate set for regular companies⁶⁰ (a company⁶¹ other than a Small Business Corporation, and certain others⁶²).

In 2002 the thresholds of these two brackets were adjusted: the rates were 15% of taxable income up to R150 000 and 30% of the amount of taxable income over R150 000.⁶³ Regular companies continued to pay 30%.⁶⁴

In 2005 rates for Small Business Corporations were set in three brackets: at 0% of taxable income up to R35 000, 10% of the amount of taxable income over R35 000 up to R250 000 and 29% per cent of the amount of taxable income over R250 000.⁶⁵ Regular companies paid 29%.⁶⁶

In 2006 the thresholds of these three brackets were adjusted: the rates were 0% on the first R40 000, 10% of the amount over R40 000 up to R300 000 and 29% of the amount over R300 000.⁶⁷ Regular companies continued to pay 29%.⁶⁸

In 2013 the rates of tax leviable on a Small Business Corporation were set in four brackets:⁶⁹ at 0% of taxable income up to R67 111, 7% of the amount of taxable income over R67 111 up to R365 000,⁷⁰ 21% of the amount of taxable income over R365 000 up to R550 000⁷¹ and 28% of the amount of taxable income over R550 000. The rate for regular companies is 28%.⁷² These rates apply in respect of any year of assessment ending during the period of 12 months ending on 31 March 2014.⁷³

A regular company, on taxable income of R550 000, pays fully 28% thereof in tax, being R154 000. A Small Business Corporation, on the same taxable income, pays only R80 554 in tax.⁷⁴ This means that on taxable income of R550 000 a Small Business Corporation enjoys a tax benefit of R73 446 relative to a regular company.⁷⁵

The National Treasury and South African Revenue Service reported in 2013 that, of the 600 526 companies assessed in the 2011 tax year, 103 928 were assessed as Small Business Corporations and paid tax at graduated income-tax rates instead of a fixed rate.⁷⁶

As has been reported,⁷⁷ onerous rules that disqualify certain types of businesses and owners from benefiting from the tax are partly responsible for the low uptake of the Small Business Corporation tax regime: Business owners can't have shares in more than one business, can't derive more than 20% of their revenue from investments and rendering personal service and can't be a personal service provider unless they employ three or more people.

Many personal service providers start off with one person before expanding, and the rule disqualifies many start-ups in the services sector.

Immediate deduction of investment expenditure by SBCs in manufacturing assets

In determining a person's taxable income from carrying on business, expenditure incurred in the production of the income is allowed as a deduction from the income, if the expenditure is not of a capital nature.⁷⁸

Expenditure incurred in acquiring machinery used in a business is normally expenditure of a capital nature not allowed as a deduction from income.⁷⁹

But the Act allows businesses to make specific deductions for machinery. For example:

General Wear-and-Tear and Depreciation⁸⁰ Deduction: A deduction of the sum the Commissioner thinks just and reasonable as the amount by which the value of machinery, plant, etc. acquired and used by the taxpayer for the purpose of his trade was diminished by wear and tear or depreciation during the year is allowable (unless a '40/20/20/20 Depreciation Deduction' (below) or the 'Small Business Corporation deduction' (later below) or another specific deduction⁸¹ is allowable).⁸²

'40/20/20/20' Depreciation Deduction:⁸³ For machinery which a taxpayer brings into use both for the purpose of his trade and in a process of manufacture that he carries on in the course of his business, a deduction of 40% of his cost of acquiring the machinery is allowable in the year it is brought into use and three succeeding years.⁸⁴

The Act allows more generous deductions for Small Business Corporations:

Immediate deduction of expenditure by Small Business Corporations in manufacturing assets, introduced in 2001

In his 2001 Budget Speech the Minister said:⁸⁵

‘Government continues to support small businesses, which are key engines of job creation. In the 2000 Budget, a reduced tax rate of 15 per cent of the first R100 000 of taxable income was introduced for certain small businesses. The tax privileges for small businesses are extended in this Budget to allow for the immediate deduction of investment expenditure in manufacturing assets in the year in which the investment is made.’

Provision for an immediate deduction of expenditure in manufacturing assets for Small Business Corporations⁸⁶ was duly inserted into the Act in 2001.⁸⁷ It provides:

Where plant or machinery owned by a Small Business Corporation or acquired by it as purchaser under an instalment credit agreement is brought into use for the first time by it for the purpose of its trade,⁸⁸ and is used by it directly in a process of manufacture⁸⁹ carried on by it, a deduction is allowed in the year the asset is brought into use equal to the cost of the asset.⁹⁰

‘50:30:20’ depreciation deduction for other assets acquired by SBCs, introduced in 2005

In his 2005 Budget Speech the Minister said:⁹¹

‘Small businesses will also be eligible for a simplified 50:30:20 depreciation write-off rate for non-manufacturing assets, while manufacturing assets will continue to qualify for 100 per cent write-off.’

Provision for ‘50:30:20’ depreciation of non-manufacturing assets⁹² for Small Business Corporations⁹³ was duly inserted into the Act in 2005.⁹⁴ It provides:

Where a Small Business Corporation acquires machinery, plant, etc. for use by it for the purpose of its trade, and for which a General Wear-and-Tear and Depreciation Deduction⁹⁵ is allowable, the deduction allowable must, at the election of the Small Business Corporation, be either

the General Wear-and-Tear and Depreciation Deduction, or

50% of the asset’s cost in the year it was first brought into use, 30% the following year and 20% in the third year.⁹⁶

Turnover tax payable by Micro Businesses, introduced in 2008

In his 2008 Budget Speech the Minister said:⁹⁷

‘[T]he 2008 Budget reduces the administrative burden on small businesses by introducing a presumptive turnover tax as an alternative to income tax and VAT for businesses with a turnover less than R1 million a year.’

Provision for this turnover tax was made that year:⁹⁸

A turnover tax is payable by a person that was a registered micro business in a year of assessment, on its taxable turnover that year.⁹⁹ The rates of tax chargeable must be fixed annually by Parliament.¹⁰⁰

A person qualifies as a Micro Business if the person is a natural person or company (including a cooperative or close corporation¹⁰¹), if its qualifying turnover (receipts from carrying on business activities excluding amounts of a capital nature¹⁰² for the year doesn't exceed R1 million,¹⁰³ and if it does not fall in any of the disqualifications (similar in some respects to those applicable to a Small Business Corporation).¹⁰⁴

A person that meets these requirements can elect to be registered as a Micro Business.¹⁰⁵

The taxable turnover of a registered Micro Business in a year of assessment consists of amounts not of a capital nature received by the business in the year from carrying on business activities, with some inclusions (50% of receipts of a capital nature from disposal of fixed property¹⁰⁶ or other assets used mainly for business other than a financial instrument; and, in the case of a company, other than dividends) and exclusions (investment income in the case of a natural person, specified government grants).¹⁰⁷

The business must, in the first six months of the year of assessment, estimate its taxable turnover for the whole year, calculate the tax payable on the estimate and pay half the tax. The estimate can't be less than its taxable turnover the previous year unless the Commissioner agrees. The business must, by the last day of the year, estimate its taxable turnover for the whole year again, calculate the tax payable on this estimate and pay it, less the amount paid in the half-year.¹⁰⁸

If its year-end estimate is less than 80% of taxable turnover for the year, a penalty of 20% of the difference between the tax payable on 80% of the taxable turnover for the year and the tax payable on the estimate must be charged. If the Commissioner is satisfied, in full or part, that the estimate was not deliberately or negligently understated and was seriously made based on information available, the Commissioner must waive the penalty in full or part.¹⁰⁹

The total amount received from carrying on business activities by a connected person in relation to a person qualifying as a micro business must be included in the qualifying turnover of the latter for purposes of determining if his qualifying turnover for a year exceeds the R1 million ceiling, if the Commissioner is satisfied that the connected person carries on business activities that should properly be regarded as forming part of the business activities carried on by the latter and a main reason for the connected person carrying on business activities in the way he does is so that the qualifying turnover of the latter does not exceed the ceiling.¹¹⁰

A registered micro business need only retain records of its amounts received and dividends declared in a year of assessment, and its assets as at the end of the year with a cost price of more than R10 000 and liabilities as at the end of the year that exceeded R10 000.¹¹¹

Amounts received by registered Micro Businesses are exempt from normal income tax, other than investment income or remuneration received by natural persons registered as Micro Businesses.¹¹²

A dividend¹¹³ is exempt from dividend tax (15% of the dividend paid by any company¹¹⁴) if the beneficial owner is a holder of shares in a registered Micro Business paying the dividend, to the extent that aggregate dividends paid by the business to holders of shares in it in the year of assessment in which it is paid don't exceed R200 000.¹¹⁵

A registered micro business may elect to be deregistered, but must not be deregistered unless it has been a registered micro business for at least three years.¹¹⁶

A graduated turnover tax rate structure in five brackets was introduced, in 2009,¹¹⁷ for any year of assessment ending in the 12-month period ending 31 March 2010:¹¹⁸

- 0% on the amount of taxable turnover up to R100 000,
- 1% on the amount of taxable turnover over R100 000 up to R300 000,
- 3% on the amount over R300 000 up to R500 000,
- 5% on the amount over R500 000 up to R750 000, and
- 7% on the amount over R750 000 (up to the R1 million ceiling).

In 2010 the same graduated rate structure in five brackets was set¹¹⁹ for a year of assessment ending in the 12-month period ending 31 March 2011.¹²⁰

In 2011,¹²¹ slightly-more generous rates and brackets were set for any year of assessment commencing 'on or after 1 March' 2011,¹²² as follows:¹²³

- 0% on the amount of taxable turnover up to R150 000,
- 1% on the amount of taxable turnover over R150 000 up to R300 000,
- 2% on the amount over R300 000 up to R500 000,
- 4% on the amount over R500 000 up to R750 000, and
- 6% on the amount over R750 000 (up to the R1 million ceiling).

In 2012 these rates and brackets were retained,¹²⁴ for a year of assessment ending in the 12-month period to 31 March 2013.¹²⁵

Similarly in 2013 the same rates and brackets were also kept,¹²⁶ for a year ending in the 12 months to 31 March 2014.¹²⁷

In his 2012 Budget Speech the Minister announced that Micro Businesses will be able to pay certain amounts in respect of their employees twice a year, which meant that 'the number of returns and payments a year will be reduced [...] to just two.'¹²⁸

Accordingly in 2012 provision was made for Micro Businesses to pay employees' tax ('PAYE') deductions to the Commissioner only twice a year:¹²⁹

A registered micro business may elect to pay to the Commissioner at the end of each of the first and six-month periods of a year of assessment, the amounts which it has deducted or withheld during those periods in respect of—

- Employees' tax deductible from remuneration payable to its employees (usually payable monthly to the Commissioner¹³⁰);

In 2013 this twice-annual payment facility was expanded,¹³¹ with effect from 1 March 2014 in tax periods commencing on or after that date,¹³² to cover skills development levies and employer's and employee's unemployment insurance contributions:

A registered micro business may elect to pay to the Commissioner at the end of each of the first and six-month periods of a year of assessment, the amounts which it has deducted or withheld during those periods in respect of:

Skills development levies (an amount, usually payable to the Commissioner by an employer monthly,¹³³ calculated as a percentage of the remuneration paid to an employee during a month;¹³⁴ and

Unemployment insurance contributions (an amount payable by an employee but deductible by his employer from the employee's remuneration¹³⁵ and an amount payable by the employer, both calculated as percentages of the remuneration paid to the employee during a month,¹³⁶ and usually payable to the Commissioner by the employer monthly¹³⁷).

If a registered Micro Business has made such an election to pay twice a year, the election must apply to all the amounts deducted or withheld¹³⁸ (i.e., employees' tax, skills development levies, and employer's and employee's unemployment insurance contributions).

It was reported in August 2013 that figures from the South African Revenue Service showed that in the 2012 tax year just 8 493 Micro Businesses had registered for turnover tax.¹³⁹

As has been pointed out,¹⁴⁰ turnover tax has the serious drawback that Micro Businesses pay tax regardless of whether they make a profit or not, whereas under normal income tax they would not pay tax in the event of a loss. Once signed up for turnover tax, a Micro Businesses must stay in the system for at least three years.

VAT returns

Persons who make supplies in the course of an enterprise must register as vendors under the Value-Added Tax Act¹⁴¹ if the value of taxable supplies they made in the previous twelve months exceeded a specified amount.¹⁴² This amount was R300 000 until March 2009, when it was raised to R1 million.¹⁴³

Vendors must file tax returns and pay to the Commissioner any value-added tax payable, at the end of every 'tax period' applicable to the category of vendors concerned.¹⁴⁴ The Act provides for vendor categories each of whose tax periods are periods of one, two, four, six and 12 months¹⁴⁵ depending on various criteria.¹⁴⁶

The category of vendors whose tax period is six months¹⁴⁷ includes registered Micro Businesses that have made written application to the Commissioner to be placed in this category.¹⁴⁸ (This dispensation was introduced in 2012, with effect from 1 March 2014.¹⁴⁹)

There is also a category of vendors with tax periods of four months comprising vendors the value of whose taxable supplies over 12 months does not exceed R1,5 million.¹⁵⁰ (This was introduced in 2005¹⁵¹ with a ceiling of R1 million, which was increased in 2006¹⁵² to R1,2 million, which was increased to the present R1,5 million in 2008.¹⁵³)

Venture capital deductions

Provision was made in the Income Tax Act¹⁵⁴ in 2008 (and revised in 2009¹⁵⁵) with effect from July 2009¹⁵⁶ (and further revised in 2011¹⁵⁷) for the deduction of expenditure for the issue of shares in venture capital companies:

There must be allowed as a deduction from the income of a taxpayer expenditure actually incurred by him in acquiring venture capital shares issued to him by a venture capital company.¹⁵⁸

A venture capital company must be approved by the Commissioner.¹⁵⁹

To be approved, a venture capital company must apply for approval to the Commissioner, who must be satisfied that its sole object is the management of investments in 'qualifying companies' that the tax affairs of the company are in order, that it has complied with all the relevant provisions of the laws administered by the Commissioner, and that the company is licensed by the registrar of financial services providers¹⁶⁰ to act as a financial services provider.¹⁶¹

A 'qualifying company' is any company, if it is not a controlled group company, if its tax affairs are in order and it has complied with all relevant provisions of the laws administered by the Commissioner; if it is unlisted; if it is not carrying on an 'impermissible trade'; and if investment income derived by the company in any year of assessment does not exceed 20% of its gross income that year.¹⁶²

An 'impermissible trade' is any trade involving immovable property other than as an hotel keeper; any trade carried on by a bank or long- or short-term insurer or involving money-lending or hire-purchase financing; any trade involving financial or advisory services including legal, tax advisory, stock-broking or management consulting services, auditing or accounting services; any trade involving gambling; any trade involving liquor, tobacco, arms or ammunition; or any trade mainly outside the country.¹⁶³

If in any year of assessment a taxpayer incurs expenditure and as after the acquisition of a venture capital share in a venture capital company he is a connected person in relation to that venture capital company, no deduction must be allowed in that year for any expenditure incurred by him in acquiring any venture capital share issued to him by that venture capital company.¹⁶⁴

If, after 36 months from the approval of a venture capital company, the Commissioner is not satisfied that at least 80% of the expenditure incurred by the company to acquire assets held by it was incurred to acquire 'qualifying shares' issued by qualifying companies each of which after the issue held assets with book value not exceeding R20 million¹⁶⁵ or that no more than 20% of expenditure incurred by the company to acquire qualifying shares was for shares issued by one qualifying company, the Commissioner must withdraw the approval, with effect from the date of approval of the company as a venture capital company¹⁶⁶ if corrective steps acceptable to the Commissioner are not taken by the company in a stated period.¹⁶⁷

'Qualifying shares' means equity shares held by a venture capital company which is issued to it by a qualifying company, and does not include any share which would have constituted a hybrid equity instrument but for the three-year period required for hybrid equity instruments or which constitutes a third-party backed share.¹⁶⁸

If the Commissioner withdraws approval, an amount of 125% of the expenditure incurred by any person for the issue of shares held in the company must be included in the income of the company in the year of assessment in which the approval is withdrawn.¹⁶⁹

If in any year of assessment any loan or credit has been used by a taxpayer for payment or financing of any portion of any expenditure in acquiring venture capital shares and any portion of that loan or credit is owed by the taxpayer on the last day of the year, the amount which may be taken into account as expenditure that qualifies for a deduction must be limited to the amount for which the taxpayer is deemed to be at risk on that day. The taxpayer must be deemed to be at risk to the extent that the incurring of the expenditure or the repayment of any loan or credit used by the taxpayer for the payment or financing of the expenditure would (having regard to any arrangement entered into) result in an economic loss to the taxpayer were no income to accrue to the taxpayer in future years from the disposal of any venture capital share issued to the taxpayer as a result of the incurring of that expenditure. The taxpayer must not be deemed to be at risk, to the extent that: the loan or credit is not repayable within five years; and any loan or credit used by the taxpayer for the payment or financing of the whole or any portion of any expenditure is (having regard to any arrangement) granted directly or indirectly to the taxpayer by the venture capital company as a result of the incurring of the expenditure.¹⁷⁰

No deduction will be allowed for shares acquired after June 2021.¹⁷¹

The Act says that various amounts allowed to be deducted in the current or any previous year of assessment (including expenditure incurred in acquiring venture capital shares issued to the taxpayer by a venture capital company), which have been recovered or recouped during the current year of assessment (i.e., to the extent of the initial venture capital company investment¹⁷²), shall be included in the taxpayer's income.¹⁷³ Any amount allowed as a deduction is recouped¹⁷⁴ upon the disposal of venture capital shares. Any amount recouped is automatically included in the gross income of the person disposing of the shares, irrespective of the capital or revenue nature thereof. An amount received or accrued on or after 1 July 2009 for the sale of venture capital shares that is recouped, will not¹⁷⁵ be deemed to be of a capital nature.¹⁷⁶ An amount received or accrued in excess of the amount recouped will, however, be deemed to be of a capital nature provided that the shares have been held for at least three continuous years.¹⁷⁷

Various weaknesses have been identified and criticisms levelled against the venture capital tax incentive:¹⁷⁸

'Four years after the venture capital tax incentive was introduced, only one small business, an IT firm, had benefited from a venture capital investment.

'Despite the incentive having been overhauled in 2011, after a campaign by industry members against the onerous criteria needed to qualify for the incentive, not all the onerous criteria were removed.

'The incentive aims to boost venture capital investments in small businesses by allowing individuals to make upfront tax deductions if they invest in venture capital companies, which in turn invest in certain kinds of small enterprises.

'South Africa Venture Capital Association (Savca) chairperson Erika van der Merwe said that the small uptake was due to the incentive not having been widely marketed by SARS and it not being perceived as 'sufficiently attractive' by the venture capital market and high-net-worth individuals.

'Jeff Miller, director of Grovest, said the provision in the 12J regulations (in which a deduction is recouped if an individual disposes of their shares in a venture capital company) might have put some investors off. It means that when investors chose to sell shares, SARS would — in one year — recoup the full amount of an investor's deduction and apply capital gains tax to any profits made from selling of the shares.

'Miller pointed out that such a provision does not exist for the UK's venture capital incentive. Three years ago the recoupment rule was cited by one venture capitalist as the key reason why his fund was unable to raise sufficient money from investors using the incentive.

'Investors might also be put off by the high penalties. SARS can issue a fine equal to 125% of the amount contributed by an investor if SARS opts to later withdraw the status of any investment firm as a venture capital company.

'Venture capital companies also have to be vetted by SARS first and licensed with the Financial Services Board (FSB) before they can begin operating. Miller said that Grovest's application to the FSB took nearly a year.

'The incentive should be spurring more angel investors to investing in small companies, but Brett Commaille, who runs angel investment network Angel Hub, said unlike in the UK, investors are not given the choice to place investment directly in firms to benefit from tax rebates, but have to do so via a venture capital company.

Commaille points to McKinsey & Company data on venture capital incentives, where 74% of UK angel investors reported that the tax incentives played a highly significant role in their decision to invest in a small business.'

—ooo0ooo—

Prepared by

Gary Moore, Consultant, Free Market Foundation

Eustace Davie, Director, Free Market Foundation

About the Free Market Foundation

The Free Market Foundation is an independent public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

See more at: <http://www.freemarketfoundation.com/about/who-we-are#sthash.8H58hvPM.dpuf>

Endnotes

- 1 The Davis Tax Committee, 5 November 2013, Media Statement: The Davis Tax Committee Calls for Contributions.
- 2 Davis Tax Committee, 5 November 2013, Media Statement: Committee Calls for Contributions.
- 3 Committee's Terms of Reference, paragraph 1.
- 4 Terms of Reference, paragraph 2.
- 5 Paragraph 3.
- 6 Committee Terms of Reference.
- 7 Tax, I. Hetherington & E. Davie, 1999, part of the series *Laws Affecting Small Business* compiled by the Free Market Foundation and published by the Friedrich-Naumann-Stiftung, Johannesburg.
- 8 *Laws Affecting Small Business, Tax* (see endnote 7), 'Synopsis'.
- 9 R215 000 is the equivalent after adjustment for inflation of the amount of R100 000 which we proposed in 1999: see endnote 7.
- 10 *Laws Affecting Small Business: Tax*, Recommendation 2.
- 11 These submissions are derived in updated form from *Laws Affecting Small Business: Tax* (see endnote 7), 'The case for simplifying tax laws and regulations'.
- 12 *National Income Dynamics Study 2013 Wave 3 Overview*, p.3. (Southern Africa Labour and Development Research Unit, School of Economics, University of Cape Town, 17 December 2013.)
- 13 *Laws Affecting Small Business: Tax*, Recommendation 4.
- 14 Income Tax Act 58 of 1962 s 5(1).
- 15 Value-Added Tax Act 89 of 1991 s 15(1).
- 16 Value-Added Tax Act s 15(2)(b)(i) and (ii).
- 17 Value-Added Tax Act s 15(2A).
- 18 Value-Added Tax Act s 23(1).
- 19 Value-Added Tax Act s 23(3)(b)(i) and (ii).
- 20 Value-Added Tax Act s 15(2B).
- 21 Income Tax Act s 24(1).
- 22 Income Tax Act s 24(2).
- 23 *Laws Affecting Small Business: Tax*, Recommendation 5.
- 24 Income Tax Act s 64C(2).
- 25 Income Tax Act s 64B.
- 26 Income Tax Act s 64B(19) read with s 64D 'effective date'; Revenue Laws Amendment Act 60 of 2008 s 55(2) and s 56(2), Govt Notice 1073 of 20 December 2011.
- 27 Act 34 of 2005.
- 28 National Credit Act s 105(1)(a) and (3)(a) read with s 171(1)(a).
- 29 National Credit Act s 1 'consumer' para (h).
- 30 National Credit Act s 1 'credit agreement'.
- 31 National Credit Act s 8(1)(b) and (4)(f)(ii).
- 32 See National Credit Act s 10(1)(b)(iii)(aa).
- 33 Govt Notice R489 of 31 May 2006, 'Regulations made in terms of the National Credit Act, 2005,' reg 42.
- 34 National Credit Act s 4(1)(a)(i) read with s 7(1).
- 35 See National Credit Act s 7(1) read with s 2(4); Govt Notice 713 of 1 June 2006, 'Determination of Thresholds', reg 2.
- 36 National Credit Act s 9(4)(b) read with s 7(1)(b).
- 37 Govt Notice 713 of 1 June 2006, 'Determination of Thresholds', reg 3(2).
- 38 National Credit Act s 4(1)(b) read with s 7(1).
- 39 See endnote 35.
- 40 2014 Budget Speech, Minister of Finance, Pravin Gordhan, 26 February 2014, p 18.
- 41 2014 Budget Speech, p 17.
- 42 2014 Budget Speech, p 18.
- 43 Income Tax Act s 1(1), 'company', para (f).
- 44 In terms of the Co-operatives Act of 1981 or of 2005: Income Tax Act s 1(1) 'co-operative'.
- 45 Income Tax Act s 5(1)(d).
- 46 Section 5(2).
- 47 The current definition of a Small Business Corporation appears in the Income Tax Act in extensive form in s 12E(4)(a)(i) and (ii)(aa)–(ff)(A) and (B), (hh)(A) and (B) and (ii), (iii) and (iv), (c) and (d). The definition (abbreviated and paraphrased) is to this effect: A Small Business Corporation means a private company, close corporation or co-operative, if at all times in the year of assessment all holders of its shares are natural persons, and—
 - (i) Its gross income for the year does not exceed R20m;
 - (ii) None of its shareholders or members at any time during the year of assessment holds shares or interests in the equity of another company (other than permissible shares and interests, viz. shares in a listed company, property collective-investment scheme, or a sectional-title body corporate or share-block company or the like, a friendly society, or a venture-capital company; or less than 5% of the interest in a social, consumer, burial-society or similar co-operative whose trading income in the year is all from members, or

shares in an entity that has not during any year carried on a trade or owned assets exceeding R5 000 in value; or shares in an entity that has taken formal steps to wind up or deregister);

- (iii) No more than 20% of its income and capital gains consists of (a) investment income (dividends, royalties, rent, annuities or the like; interest or income subject to the same revenue treatment as income from money lent; and proceeds from investment or trading in financial instruments, marketable securities or fixed property), and (b) income from rendering a personal service (a service in the field of accounting, actuarial science, architecture, auctioneering, auditing, broadcasting, consulting, etc., etc., if performed personally by a person holding an interest in the entity, which does not throughout the year employ three or more full-time employees engaged full-time in the entity's business of rendering that service, other than a shareholder or member of the entity or person connected to him); and
- (iv) The company is not a personal service provider (viz., a company where services rendered on its behalf to its clients are rendered personally by a person connected to the company, and either (a) this person would be regarded as the client's employee if rendered by him directly to the client rather than on behalf of the company, or (b) the duties must be performed mainly at the client's premises and this person or the company is subject to control or supervision by the client as to how they are or are to be performed, or (c) more than 80 per cent of the income of the company during the year of assessment from services rendered consists or is likely to consist of amounts received directly or indirectly from any one client or any institution associated with the client, except if the company throughout the year employs three or more full-time employees engaged full-time in the business of the company rendering such services, other than an employee who is a shareholder in the company or person connected to him).

48 By the Taxation Laws Amendment Act 30 of 2000 Schedule 1 para 4(b).

49 By the Taxation Laws Amendment Act 30 of 2002 s 17(1).

50 By the Exchange Control Amnesty and Amendment of Taxation Laws Act 12 of 2003 s 37(1).

51 By the Taxation Laws Amendment Act 9 of 2005 s 9(1)(d).

52 By the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006 s 24.

53 By the Rates and Monetary Amounts and Amendment of Revenue Laws Act 23 of 2013 s 7(1).

54 See, for example, s 9(2)(b) read with s 9(1)(d) of the Taxation Laws Amendment Act 9 of 2005 (referred to in endnote 51).

55 D Clegg & R Stretch *Income Tax in South Africa*, para 2.1.16.

56 Rates and Monetary Amounts and Amendment of Revenue Laws Act 23 of 2013 s 7(2).

57 Trevor A Manuel, Minister of Finance, Budget Speech, 23 February 2000, p 20.

58 Taxation Laws Amendment Act 30 of 2000 s 12(b) read with Schedule 1 paras 2(b) and 4(b).

59 Revenue Laws Amendment Act 30 of 2000 s 12(b) read with Schedule 1 para 2(b).

60 Ibid schedule 1 para 2(a).

61 Including close corporations and co-operatives: endnotes 43 and 44 above.

62 Gold-mining companies, long-term insurers, public-benefit organisations, recreational clubs and registered micro businesses.

63 Taxation Laws Amendment Act 30 of 2002 s 8(c) read with schedule 1 para 2(b).

64 Ibid schedule 1 para 2(a).

65 Taxation Laws Amendment Act 9 of 2005 s 2(b) read with schedule 1 para 2(b).

66 Ibid schedule 1 para 2(a).

67 Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006 s 18(b) read with schedule 1 para 2(b).

68 Ibid schedule 1 para 2(a).

69 Rates and Monetary Amounts and Amendment of Revenue Laws Act 2013 s 2(3)(b) read with Appendix I para 5.

70 7 % of the difference between R67 111 and R365 000 is R20 852.

71 21 % of the difference between R365 000 and R550 000 is R38 850. Plus R20 852 (tax on the amount between R67 111 and R365 000) a Small Business Corporation with taxable income of R550 000 will pay tax of R59 702.

72 Rates and Monetary Amounts and Amendment of Revenue Laws Act 2013 s 2(3)(b) read with Appendix I para 3(a).

73 Rates and Monetary Amounts and Amendment of Revenue Laws Act 2013 s 2(3)(b) read with Appendix I paras 3 and 5.

74 R20 852 plus R59 702: see endnotes 70 and 71).

75 The difference between R154 000 and R80 554.

76 National Treasury and SARS, 2013 Tax Statistics, p 91.

77 *Mail & Guardian*, 30 August 2013, 'Bitter end of tax restrictions for micro businesses'.

78 Income Tax Act s 11(a).

79 D Clegg & R Stretch *Income Tax in South Africa*, para 10.2.9.

80 Silke (ed. A P de Koker & R C Williams) *South African Income Tax*, para 8.117.

81 Under any of the specific-deduction provisions for: machinery or plant used in farming or renewable-energy production, hotel assets, aircraft or ships, assets used for storage or packing of agricultural products, rolling stock, or environmental treatment-and-recycling or waste-disposal assets: ss 12B, 12C, 12DA and 37B of the Act.

82 Income Tax Act s 11(e). There are provisos.

83 Silke (op cit), para 8.39B.

84 Income Tax Act s 12C(1)(a) read with s 12C(1) proviso (c).

85 Budget Speech, Minister of Finance, T A Manuel, 21 February 2001, p 40.

86 Section 12E(4)(a)(i).

87 By the Revenue Laws Amendment Act 19 of 2001, s 12.

88 Other than mining or farming.

89 Or a process of a similar nature, in the Commissioner's opinion.

90 Section 12E(1)

- ⁹¹ Budget Speech, 2005, Minister of Finance, Trevor A Manuel, 23 February 2005, p 28.
- ⁹² Silke (op cit), para 8.39D.
- ⁹³ Section 12E(4)(a)(i).
- ⁹⁴ By the Taxation Laws Amendment Act 9 of 2005, s 9(1)(a).
- ⁹⁵ See text accompanying endnotes 80 and 82.
- ⁹⁶ Section 12E(1A)(a) and (b).
- ⁹⁷ Budget Speech, 2008, Minister of Finance, Trevor A Manuel, 20 February 2008,
- ⁹⁸ By the Revenue Laws Amendment Act 60 of 2008, s 54(1).
- ⁹⁹ Income Tax Act, s 48A.
- ¹⁰⁰ Income Tax Act, s 48B(1).
- ¹⁰¹ Income Tax Act, s 1(1) sv 'company' paras (c) and (f).
- ¹⁰² Income Tax Act, Sixth Schedule para 1 'qualifying turnover'.
- ¹⁰³ Income Tax Act, s 48 read with Sixth Schedule para 2(1).
- ¹⁰⁴ Income Tax Act, Sixth Schedule para 3(a), (b)(i) and (ii), (c), (e)(i) and (ii), (f)(i), (ii) and (iii)(aa)(A) and (B) and (bb), (iv) and (v), (g)(i), (ii) and (iii) read with para 4. Briefly paraphrased:
A person does not qualify as a micro business for a year of assessment, if—
- (a) the person at any time in the year holds shares or an interest in the equity of a company (other than permissible shares and interests, viz. a shares or interest in a listed company, collective investment scheme portfolio, sectional-title body corporate or share-block company or the like, or venture-capital company; or less than 5% of the interest in a social, consumer, burial-society or similar co-operative whose trading income in the year is all from members; or less than 5% of the interest in a savings co-operative bank; or a friendly society);
 - (b) more than 20 per cent of the person's total receipts during that year consists of (i) if the person is a natural person, income from rendering a professional service, (ii) if the person is a company, investment income and income from rendering a professional service.
 - (c) at any time in that year the person is a personal service provider, or labour broker (other than a labour broker exempted from being treated an employee for the withholding of employee's tax);
 - (d) the amounts received by the person from the disposal of fixed property and any other capital asset used mainly for business, other than a financial instrument, exceeds R1,5 million over a period comprising the current and the immediately preceding two years of assessment, or the shorter period during which he was a registered micro business;
 - (e) in the case of a company, its year of assessment ends on a date other than the end of February; or at any time during its year of assessment any shareholder is not a natural person or holds any shares or interest in the equity of another company (other than a listed company, collective investment scheme portfolio, etc., see para (a) above) unless that other company has not during any year of assessment carried on any trade and owned assets with a total market value exceeding R5 000; or taken formal steps to wind up or deregister; or if it is a public benefit organisation or recreational club; or (if the person is a member of a partnership in that year of assessment) any partner is not a natural person, or the person is a partner in more than one partnership in that year.
- ¹⁰⁵ Income Tax Act, Sixth Schedule para 8(1). A registered micro business may voluntarily elect to be deregistered, provided it has been a registered micro business for at least three years: Sixth Schedule para 9.
- ¹⁰⁶ Excluding trading stock.
- ¹⁰⁷ Income Tax Act, Sixth Schedule para 5 read with paras 6 and 7.
- ¹⁰⁸ Paras 11(1), (2) and (4).
- ¹⁰⁹ Para 11(6) and (7).
- ¹¹⁰ Para 13.
- ¹¹¹ Para 14.
- ¹¹² Income Tax Act s 10(1)(zj).
- ¹¹³ Other than one *in specie*.
- ¹¹⁴ Income Tax Act s 64E(1).
- ¹¹⁵ Income Tax Act s 64F(1)(h).
- ¹¹⁶ Income Tax Act, Sixth Schedule para 9.
- ¹¹⁷ Taxation Laws Amendment Act 17 of 2009, s 6(2).
- ¹¹⁸ Taxation Laws Amendment Act 2009, Schedule 1 para 97.
- ¹¹⁹ Taxation Laws Amendment Act 7 of 2010, s 5(2).
- ¹²⁰ Taxation Laws Amendment Act 2010, Schedule 1 para 7.
- ¹²¹ Taxation Laws Amendment Act 24 of 2011, s 6(2) and Schedule 1 para 7.
- ¹²² Taxation Laws Amendment Act 2011, s 6(6).
- ¹²³ Taxation Laws Amendment Act 2011, Schedule 1 para 7.
- ¹²⁴ Rates and Monetary Amounts and Amendment of Revenue Laws Act 13 of 2012 s 1(2) and (5).
- ¹²⁵ Rates and Monetary Amounts and Amendment of Revenue Laws Act 2012 Schedule 1 para 6.
- ¹²⁶ Rates and Monetary Amounts and Amendment of Revenue Laws Act 23 of 2013 s 2(2) and (4)
- ¹²⁷ Rates and Monetary Amounts and Amendment of Revenue Laws Act 2013 Schedule 1 para 6.
- ¹²⁸ 2012 Budget Speech, Minister of Finance Pravin Gordhan, 22 February 2012, p 15.
- ¹²⁹ Income Tax Act, Sixth Schedule para 11(4A).
- ¹³⁰ Income Tax Act s 89bis(1) read with Fourth Schedule para 2(1).
- ¹³¹ By the Tax Administration Laws Amendment of Act 39 of 2013 s 15(1)(a).
- ¹³² Tax Administration Laws Amendment of Act 2013, s 15(2).

- ¹³³ Skills Development Levies Act 9 of 1999, s 6(1).
- ¹³⁴ Skills Development Levies Act, s 3(1) and (4).
- ¹³⁵ Unemployment Insurance Contributions Act 4 of 2002, s 7(1).
- ¹³⁶ Unemployment Insurance Contributions Act, s 6(1)(a) and (b).
- ¹³⁷ Unemployment Insurance Contributions Act, s 8(1).
- ¹³⁸ Income Tax Act, Sixth Schedule para 11(4B).
- ¹³⁹ *Mail & Guardian*, 30 August 2013, 'Bitter end of tax restrictions for micro businesses'.
- ¹⁴⁰ *Mail & Guardian*, 30 August 2013, *ibid*.
- ¹⁴¹ Value-Added Tax Act 89 of 1991 s 23(1).
- ¹⁴² Value-Added Tax Act s 23(1)(a).
- ¹⁴³ By the Revenue Laws Amendment Act 60 of 2008 s 113(1)(a).
- ¹⁴⁴ Value-Added Tax Act, s 28(1).
- ¹⁴⁵ Value-Added Tax Act, s 27(1).
- ¹⁴⁶ Value-Added Tax Act s 27(2)–(4B).
- ¹⁴⁷ Value-Added Tax s 27(4) read with s 27(1) 'Category D'.
- ¹⁴⁸ Value-Added Tax Act s 27(4)(b).
- ¹⁴⁹ By the Tax Administration Laws Amendment Act 21 of 2012, s 30(2).
- ¹⁵⁰ Value-Added Tax s 27(4B)(a) read with s 27(1) 'Category F'.
- ¹⁵¹ By the Taxation Laws Second Amendment Act 10 of 2005, s 11.
- ¹⁵² By the Small Business Tax Amnesty and Amendment of Taxation Laws Act 6 of 2006, s 50.
- ¹⁵³ By the Taxation Laws Amendment Act 3 of 2008, s 1(6) read with Appendix III.
- ¹⁵⁴ Income Tax Act s 12J.
- ¹⁵⁵ By the Taxation Laws Amendment Act 17 of 2009, s 25.
- ¹⁵⁶ By the Revenue Laws Amendment 60 of 2008, s 27.
- ¹⁵⁷ And revised in 2012, by the Taxation Laws Amendment Act 24 of 2011 s 38.
- ¹⁵⁸ Income Tax Act s 12J(2).
- ¹⁵⁹ Income Tax Act s 12J(1) 'venture capital company'.
- ¹⁶⁰ Under ss 7 and 8 of the Financial Advisory and Intermediary Services Act 37 of 2002.
- ¹⁶¹ Income Tax Act s 12J(5)(b), (e) and (g).
- ¹⁶² Income Tax Act s 12J(1), 'qualifying company'.
- ¹⁶³ Income Tax Act s 12J(1), 'impermissible trade'.
- ¹⁶⁴ Income Tax Act s 12J(3A).
- ¹⁶⁵ R300 million, where the qualifying company was a junior mining company.
- ¹⁶⁶ I.e., retrospectively.
- ¹⁶⁷ Income Tax Act s 12J(6A).
- ¹⁶⁸ Income Tax Act s 12J(1), 'qualifying shares'.
- ¹⁶⁹ Income Tax Act s 12J(8).
- ¹⁷⁰ Income Tax Act s 12J(3).
- ¹⁷¹ Income Tax Act s 12J(11).
- ¹⁷² South African Revenue Service website, Venture Capital Companies, FAQs: 'How is the deduction recouped?', <http://www.sars.gov.za/FAQs/Pages/326.aspx> (accessed 27 February 2013).
- ¹⁷³ Section 8(4)(a).
- ¹⁷⁴ Under s 8(4)(a).
- ¹⁷⁵ Section 9C(2A).
- ¹⁷⁶ Under s 9C(2).
- ¹⁷⁷ SARS, Interpretation Note: No. 43 (Issue 4), 6 June 2012, 'Circumstances in which certain amounts received or accrued from the disposal of shares are deemed to be of a capital nature,' para 6.2.
- ¹⁷⁸ *Mail & Guardian*, 30 August 2013, 'Bitter end of tax restrictions for micro businesses'.



FREE MARKET FOUNDATION

Johannesburg

PO Box 4056 | Cramerview 2060

Tel 011 884 0270 | **Fax** 011 884 5672

Email fmf@mweb.co.za

Cape Town

PO Box 805 | Cape Town 8000

Tel 082 941 5375

Email tembanolutshungu@fmfsa.org

Durban

PO Box 17156 | Congella 4013

Tel 031 572 3308 | **Fax** 031 572 3308

Email jassonurbach@fmfsa.org

31 August 2015

Input to the Davis Tax Committee (DTC)

for the

Second Interim Report on Base Erosion and Profit Shifting (BEPS)

Introduction

The FMF is grateful for the opportunity to provide this input to assist the DTC's BEPS subcommittee with drafting its Second Interim Report on BEPS.

We agree with the DTC that South Africa already has sufficient laws to deal with BEPS. The DTC rightly says that any BEPS remedy needs to be supported by facts that shed light on how big the BEPS problem is in South Africa before legal responses follow. New research suggests that BEPS is an overstated concern.

We caution that the OECD, while saying each country is free to set up its corporate tax system and charge the rate it chooses and that non- or low taxation is not the concern, also says its BEPS Plan will impact regimes that attract foreign investors without requiring economic substance.

South Africa should continue to develop fiscal policies that encourage foreign direct investment (FDI). Evidence and logic indicate that multinational firms tend to locate greater real business activity in countries with low tax rates. We trust the DTC will not be deterred by the OECD project from assessing the benefits of economic growth and increased employment that South Africa would gain by eliminating corporate tax or reducing it in conjunction with a low flat tax for individuals as we have proposed.

Base Erosion and Profit Shifting

The DTC's Terms of Reference (TOR)¹ require it to evaluate the tax system against recent international initiatives to improve tax compliance and deal with tax base erosion. An aspect to receive specific attention is:

A review of the corporate tax system with special reference to tax avoidance (e.g. base erosion, income splitting and profit shifting, including the tax bias in favour of debt financing).²

OECD

The OECD says Base Erosion and Profit Shifting are "tax planning strategies that exploit gaps and mismatches in tax rules to make profits 'disappear' for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low, resulting in little or no overall corporate tax being paid".³

The OECD in February 2013 issued a report about addressing BEPS which declared:

Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike. While there are many ways in which domestic tax bases can be eroded, a significant source of base erosion is profit shifting. Whilst further work on the data related to base erosion and profit shifting (BEPS) is important and necessary, there is no question that BEPS is a pressing and current issue for a number of jurisdictions. ...

In order to address base erosion and profit shifting, which is fundamentally due to a large number of interacting factors, a comprehensive action plan should be developed quickly. The main purpose of that plan would be to provide countries with instruments, domestic and international, aiming at better aligning rights to tax with real economic activity.⁴

Later in 2013, the OECD issued a 15-point BEPS Action Plan to address weaknesses in current rules. The Plan calls for fundamental changes to current mechanisms.⁵

The OECD says the BEPS Action Plan is "not aimed at restricting the sovereignty of countries over their own taxes". It insists taxation is at the core of countries' sovereignty and each country is free to set up its corporate tax system and charge the rate it chooses. The Plan is said to be aimed at addressing regimes that apply to mobile activities and that "unfairly erode the tax bases of other countries". The Plan aims to end the use of shell companies to stash profits offshore or unduly claim tax treaty protection, and neutralise all schemes that "artificially shift profits offshore". The BEPS project is "not about increasing corporate taxes. Non- or low taxation is not itself the concern."⁶

But the OECD will expect low-tax countries to change their substantive tax rules to suit high-tax countries:

The OECD says the BEPS Action Plan will have an impact on regimes that seek to attract foreign investors without requiring any economic substance. A race to the bottom would ultimately drive applicable tax

¹ The Davis Tax Committee, "About Us – Our Terms of Reference" (TOR) 2013.

² TOR item 3b.

³ OECD, Centre for Tax Policy and Administration. "BEPS – Frequently Asked Questions, Background," para 47, <http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm> (accessed 28 August 2015).

⁴ OECD (2013), "Addressing Base Erosion and Profit Shifting," pp 5, 8. <http://dx.doi.org/10.1787/9789264192744-en> (accessed 28 August 2015).

⁵ OECD (2013), "Action Plan on Base Erosion and Profit Shifting," p 13. <http://dx.doi.org/10.1787/9789264202719-en>

⁶ OECD, "BEPS – Frequently Asked Questions, Background" (see above), paras 60, 62, 63.

rates on certain sources of income to zero for all countries.⁷ Actions to address BEPS will “restore both source and residence taxation” in cases where cross-border income would otherwise go untaxed or be taxed at very low rates.⁸ “Domestic tax policy cannot be designed without taking into account the effects on other countries’ policies”.⁹

DTC’s BEPS actions

The DTC in November 2013 called for input for its first BEPS report.¹⁰ It released a First Interim BEPS Report in December 2014¹¹ which deals with the seven so-called “2014 deliverables”¹² of the OECD’s 15-point Action Plan.¹³

The Report says, given the OECD’s aim of coherent solutions, that the proposed measures on the seven 2014 deliverables, while agreed, are not finalised because they may be affected by decisions to be taken on the other eight actions, the “2015 deliverables”. Measures will be implemented in domestic laws or bilateral tax treaties.¹⁴

The DTC now invites¹⁵ input to assist its BEPS subcommittee with the Second Interim BEPS Report focussing on the 2015 deliverables (the other eight OECD actions):

Action 3: Strengthen Controlled Foreign Companies Rules

Action 4: Limit Base Erosion via Interest Deductions and Other Financial Payments

Action 7: Prevent the Artificial Avoidance of Permanent Establishment (PE) Status

Action 9: Assure that Transfer Pricing Outcomes are in Line With Value Creation /Risks and Capital

Action 10: Assure that Transfer Pricing Outcomes are in Line With Value Creation /Other High-Risk Transactions

Action 11: Establish Methodologies to Collect and Analyse Data on BEPS and the Actions to Address It

Action 12: Require Taxpayers to Disclose Their Aggressive Tax Planning Arrangements

Action 14: Make Dispute Resolution Mechanisms More Effective

Action 15: Develop a Multilateral Instrument.

⁷ OECD, “BEPS – Frequently Asked Questions, Background” (see above), paras 61, 62.

⁸ OECD (2013), “Addressing Base Erosion and Profit Shifting” (see above) p 11.

⁹ OECD (2013), “Addressing Base Erosion and Profit Shifting” (see above) p 28.

¹⁰ Media Statement, 5 November 2013: The Davis Tax Committee Calls For Contributions.

¹¹ Media Statement, 23 December 2014: Release of DTC First Interim Report on BEPS for public comment.

¹² That DTC First Interim BEPS Report of December 2014 dealt with the seven OECD 2014 deliverables as follows: (Introductory background information;

(South Africa’s conceptual framework for addressing BEPS)

Action 1: Address the Tax Challenges of the Digital Economy

Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements

Action 5: Counter Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

Action 6: Prevent Treaty Abuse

Action 8: Assure that Transfer Pricing Outcomes are in Line With Value Creation / Intangibles

Action 13: Re-examine Transfer Pricing Documentation

Action 15: Develop a multilateral instrument to enable jurisdictions that wish to do so to implement

(Summary of DTC recommendations on the OECD 2014 deliverables).

¹³ OECD (2013), “Action Plan on Base Erosion and Profit Shifting,” <http://dx.doi.org/10.1787/9789264202719-en>

¹⁴ DTC First Interim BEPS Report, December 2014, p 16.

¹⁵ Media Statement, 21 May 2015: Call for Input for the Second Interim Report on BEPS by 31 August 2015.

The DTC requests persons giving input to, among other things,

- (a) Analyse the effectiveness of South African tax legislation bearing in mind South Africa needs to attract foreign direct investment and be competitive;
- (b) Provide recommendations on how tax legislation should be addressed if not effective enough to yield an optimal result for South Africa;
- (c) Consider the costs of complying with the required legislation compared to its benefits and the impact it has on ease of doing business in South Africa;
- (d) List affected non-tax areas in the South African economy;
- (e) Comment on any other BEPS concern.

DTC's First Interim BEPS Report

The relevant aspects of the DTC's First Interim BEPS Report are important enough to summarise here:

The Report asks if South Africa is bound to follow the OECD Plan. South Africa is not an OECD member, although it has OECD observer status and is a member of the OECD BEPS committee. The Report says OECD recommendations have become a globally accepted standard and "it is important for South Africa to work together with the international community to come up with a holistic approach to properly address the BEPS issues".¹⁶

Commendably, the DTC's First Interim BEPS Report stresses that South Africa's circumstances must be taken into consideration in addressing BEPS concerns. The BEPS concerns and challenges that the UK or US face may not be ones South Africa faces. Any BEPS remedy from the South African perspective needs to be supported by facts that shed light on how big the BEPS problem is in South Africa before legal responses follow.¹⁷

The DTC notes that the NDP¹⁸ says South Africa should develop fiscal policies that encourage foreign direct investment (FDI). Tax policy should not prevent economic growth. It should foster an increase in tax revenues and the tax base and job creation. Tax policy should not adversely affect South Africa as a foreign investor destination. FDI is a source of economic development and employment for developing and emerging economies.¹⁹

The First Interim BEPS Report asks to what extent BEPS is a problem in South Africa. SARS statistics do not imply the existence or non-existence of BEPS action. The Report discusses a National Treasury budget report, Reserve Bank data, and National Planning Commission views.²⁰ These are all inconclusive about BEPS action in South Africa.

The First Interim BEPS Report warns that a unilateral South African introduction of domestic legislation in anticipation of global reforms could result in a less investor-friendly tax environment and place us at a disadvantage compared to other jurisdictions without BEPS legislation in attracting much-needed FDI. Competitive pressure using tax policies is evident.

¹⁶ DTC First Interim BEPS Report, p 18.

¹⁷ DTC First Interim BEPS Report, pp 18 - 19.

¹⁸ National Planning Commission "National Development Plan: Vision for 2030 (2011).

¹⁹ DTC First Interim BEPS Report, pp 19, 26.

²⁰ DTC First Interim BEPS Report, pp 19 - 26.

The G7 (except the US) and BRICS countries have lowered corporate tax rates since 2000.²¹

Some countries have moved from worldwide (residence-based) to territorial (source) systems of taxing companies. The decision is a key policy issue depending on where a country wants to be on a spectrum from purely worldwide to purely territorial taxing.

There are international changes in taxing dividend income, with many European countries moving to classical or shareholder relief systems, away from imputation systems under which dividends are taxed at lower rate at the personal level. Yet many countries tax dividends at personal shareholder level at lower rates than the personal income tax rates levied on wage income. A reason for reducing the effective tax rate on dividends has been that it is potentially the rate faced by equity investors in a new business (since such a business does not have retained profits from existing activities available to reinvest).

South Africa cannot afford to proceed too hastily with the OECD Plan while other countries take a “wait and see” approach.²²

The First Interim BEPS Report says new BEPS rules should adhere to principles of a good tax system: Equity, efficiency, certainty and simplicity: Equity entails protecting a country’s tax base by developing domestic laws that are fair and impartial. Efficiency requires minimum distortion in allocation of resources. Certainty of the tax system is important for foreign investors and goes hand in hand with low compliance costs, and should allow as much time as possible for debate of proposed BEPS rules. Simplicity requires that corporate tax laws are not too complex; complexity is caused by taxing accruals and different treatment of debt and equity; corporate tax shelters take advantage of the taxing of income only when it is realised and of the difference between debt and equity.²³

The Report rightly says that raising tax revenues in a way broadly accepted as “fair” is more likely to achieve high levels of voluntary compliance.²⁴

The First Interim BEPS Report notes that the Exchange Control Regulations have played a role against BEPS in South Africa especially with regard to transfers related to ecommerce, intellectual property and other intangibles. The Minister of Finance has directed that liberalisation of exchange controls should aim at an end result which protects the tax base.²⁵

The Report concludes that over the years South Africa has made good progress in devising provisions to deal with BEPS and its legislation is comparable to or better than developed economies. Considering the competitive edge the country has to maintain, South Africa should consider whether it is necessary to tighten its laws any further.²⁶

²¹ DTC First Interim BEPS Report, p 27.

²² DTC First Interim BEPS Report, p 27.

²³ DTC First Interim BEPS Report, pp 28 – 30.

²⁴ DTC First Interim BEPS Report, p 30.

²⁵ DTC First Interim BEPS Report, p 33.

²⁶ DTC First Interim BEPS Report, p 33.

South Africa has anti-avoidance provisions to address BEPS including controlled foreign company (CFC) rules,²⁷ transfer pricing and thin capitalisation rules,²⁸ rules to deal with hybrid instruments, reportable arrangements rules,²⁹ and the Voluntary Disclosure Programme.³⁰ The provisions have curtailed erosion of the South African tax base.

South Africa can also address BEPS by applying its general anti-avoidance rules and the substance over form principles, even though these general provisions are mainly applied in the domestic arena. South Africa's tax treaties also contain provisions (such as the beneficial ownership provision) which can be applied to curtail the abuse of South Africa's treaties by third country residents.

Despite these provisions, tax planners take advantage of loopholes. Legislators come up with ad hoc preventative amendments which complicate the legislation and open further loopholes.³¹

The First Interim BEPS Report stresses that the main concern of the OECD Action Plan is about addressing inbound issues which involve foreign multinationals investing in a country without paying their fair share of corporate income tax to that country. However, responding to these BEPS issues should not be seen as discouraging foreign investment. The goal is to ensure that the multinationals pay their share of tax based on amounts economically attributable to their activities in the local country.³²

OECD Action 11: Establish methodologies to collect and analyse data on BEPS and the actions to address it

The OECD says about this:

Develop recommendations regarding indicators of the scale and economic impact of BEPS and ensure that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis. This will involve developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it. The work will also involve assessing a range of existing data sources, identifying new types of data that should be collected, and developing methodologies based on both aggregate (e.g. FDI and balance of payments data) and micro-level data (e.g. from financial statements and tax returns), taking into consideration the need to respect taxpayer confidentiality and the administrative costs for tax administrations and businesses.³³

We note that South Africa has institutions that can measure economic activity and which have found no material evidence of BEPS.³⁴

A recent academic analysis suggests that the impact on tax revenues of BEPS is negligible:³⁵

²⁷ Income Tax Act 58 of 1962 s 9D.

²⁸ Income Tax Act s 31.

²⁹ Tax Administration Act 28 of 2011 ss 39 - 39.

³⁰ Tax Administration Act ss 225 - 233.

³¹ DTC First Interim BEPS Report, p 37.

³² DTC First Interim BEPS Report, p 37.

³³ OECD (2013), "Action Plan on Base Erosion and Profit Shifting," pp 21 – 22.

³⁴ See above. (The First Interim BEPS Report asks to what extent BEPS is a problem in South Africa. SARS statistics do not imply the existence or non-existence of BEPS action. The Report discusses a National Treasury budget report, Reserve Bank data, and National Planning Commission views. These are all inconclusive about BEPS action in South Africa.)

³⁵ James R. Hines Jr, "Policy Forum: How Serious Is the Problem of Base Erosion and Profit Shifting?" *Canadian tax journal / Revue fiscale canadienne* (2014) 62:2, 443 – 453, p 444. (Prof Hines is a research associate of the National Bureau of

How important is the problem of BEPS from the standpoint of tax collections? The statistical evidence consistently indicates that the impact on tax revenues is only modest in magnitude. Some of the latest evidence suggests that the semi-elasticity of income reporting is roughly 0.4, which means that a corporation that is located in a country with a 25 percent tax rate, and that has the opportunity to reallocate some of its taxable income to a country with a 15 percent tax rate, will typically arrange its financial and other affairs to reallocate 4 percent of its income to the lower-rate country. Other, rather more persuasive, evidence suggests that multinational firms earning profits in high-tax countries find ways to reallocate 2 percent of those profits to low-tax foreign jurisdictions. For various reasons to be discussed, even these 2 or 4 percent figures probably overstate the potential tax revenue to be had by eradicating BEPS, but on its own terms the potential tax revenue from 2 or 4 percent of pre-tax incomes of multinational corporations would make an extremely modest contribution to the government finances of most countries. The average member country of the Organisation for Economic Co-operation and Development (OECD) in 2011 raised 8.8 percent of its total tax revenue from taxes on corporate profits, only a portion of which represented taxes on multinational corporations, 2 percent of which would be two-tenths of 1 percent of tax revenue. Even if one were to double, or quintuple, this figure, it would amount to less than 1 percent of tax revenue. From this standpoint, it appears that even a complete solution to the problem of BEPS, were one available and implementable, would have little direct impact on government finances.

The author warns against overreacting to BEPS:³⁶

If firms were able to arrange their affairs in ways that would easily reallocate pre-tax income earned in high-tax locations to alternative locations with zero or very low tax rates, then most would surely do so, and even those corporations without an international business presence would quickly establish operations in low-tax foreign locations in order to reduce their tax obligations. That corporations persist in paying taxes to governments of high-tax countries does not reflect lack of imagination or insufficient profit motive; it reflects the fact that enforcement makes tax avoidance difficult and costly.

Further evidence is available from the location of foreign business activities. Studies consistently find that multinational firms locate more employment, property, plant, and equipment in low-tax locations, and less in high-tax locations, than the structures of these economies would ordinarily warrant. This business activity pattern is itself a form of base erosion from the standpoint of high-tax countries, albeit of a rather mundane form, since it is hardly surprising that high tax rates discourage business activity, whereas low tax rates attract it.

[...] In fact, this is not what firms do: the evidence consistently indicates that multinational firms tend to locate greater real business activity in countries with low tax rates than would otherwise be expected. [...]

It is questionable whether radical reforms are justified by the very modest size of the BEPS problem. Accordingly, it is to be hoped that any actions undertaken by the international community will reflect thoughtful consideration of the magnitude of BEPS and the costs and benefits of possible reforms.

Economic Research, and research director of the International Tax Policy Forum. Univ of Michigan, Law Faculty biographies, <https://www.law.umich.edu/FacultyBio/Pages/FacultyBio.aspx?FacID=jrhines> (accessed 30 August 2015).

³⁶ James R. Hines Jr *Canadian tax journal / Revue fiscale canadienne* (2014) 62:2, 443 – 453, pp 445, 453.

Non- or low taxation is not an OECD concern

We welcome the OECD's assertion mentioned above that its BEPS project is not about increasing corporate taxes. Non- or low taxation is not the concern.

We have pointed out to the DTC previously³⁷ that corporate taxes constitute an additional tax on income that is ultimately borne by individuals. Taxes may be levied on corporations but *ordinary people* pay taxes in their roles as employees, consumers and shareholders. Most studies show that a part of corporate tax is passed on to workers in the form of lower wages and benefits. Corporate taxes also result in less money being available for companies to invest in research and development (R&D). Without this investment in R&D it would not be possible to expand business and hire more people.

Reducing or eliminating corporate tax would boost economic growth, increase South Africa's competitiveness and attractiveness as an investment destination and raise future wages. Future wages are adversely affected by high corporate tax rates because corporate taxes retard capital formation and decrease the overall level of investment, which negatively affects future labour productivity and wages.

We have urged the introduction of the Hall/Rabushka flat tax system with a low tax rate that would broaden the tax base and make tax evasion more difficult and less lucrative. Companies should be taxed at the same low flat rate as individuals.³⁸

South Africa must retain its sovereignty and be free to adopt policies that increase our global competitiveness and attractiveness as a viable investment destination if it is ever to enjoy increased economic growth and provide opportunities that will enable all South Africans to prosper.

Gary Moore
Consultant to FMF

The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction and human welfare. As a think-tank the FMF's fundamental approach to policy questions is consumer-based. Individual consumer choice is placed at the centre of any policy recommendations that the FMF espouses. Consumer satisfaction is generally achieved by an absence of barriers to entry into the provision of goods and services, allowing consumers a choice between the offerings of freely competing providers, and the absence of regulations that impose avoidable costly burdens on the providers of goods and services.

³⁷ Free Market Foundation, Submission to the Davis Tax Committee: Base Erosion and Profit Shifting (BEPS), January 2014.

³⁸ Free Market Foundation, Submission to the Davis Tax Committee [Hall/Rabushka flat tax system etc], January 2014.



FREE MARKET FOUNDATION

Johannesburg

PO Box 4056 | Cramerview 2060

Tel 011 884 0270 | Fax 011 884 5672

Email fmf@mweb.co.za

Cape Town

PO Box 805 | Cape Town 8000

Tel 082 941 5375

Email tembanolutshungu@fmfsa.org

Durban

PO Box 17156 | Congella 4013

Tel 031 572 3308 | Fax 031 572 3308

Email jassonurbach@fmfsa.org

30 September 2015

Comments to the Davis Tax Committee (DTC)

on the

DTC's First Interim Report on Estate Duty

About the Free Market Foundation

The Free Market Foundation is an independent public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Thank you for the opportunity to comment on the DTC First Interim Report on Estate Duty for the Minister of Finance.

The economic justification for the DTC report on estate duty

Before commenting specifically on the Estate Duty part of the report it is important to comment on the basic economic thinking and justifications the committee has relied upon when considering wealth taxes. The DTC seems to have been extremely one-sided in its selection of economists and theories to consider (Oxfam, Piketty, Krugman & Stiglitz) and has ignored mainstream schools of economic thought that have different things to say about inequality, poverty, wealth and tax. Had the committee considered these other voices and their empirical findings they might have made different recommendations.

1. While the committee notes the increase in income inequality within most countries in recent years they fail to notice that inequality between countries has fallen dramatically over the same period and overall global inequality is also falling.
2. They have also failed to notice that lifetime inequality is much lower than cross sectional inequality and that **measures which reduce or increase cross sectional inequality have little or no effect on lifetime inequality.**ⁱ
3. There is a significant negative correlation between per capita GDP and income Gini across countries and a zero correlation (actually insignificantly negative) between a country's level of economic freedom (market fundamentalism) as measured by the Fraser Institutes' Economic Freedom of the World Index and its income Gini.ⁱⁱ The DTC itself admits market fundamentalism is behind the recent increases in prosperity for hundreds of millions but goes on to say that market fundamentalism does not share prosperity equitably and that one needs government action and intervention to do so.ⁱⁱⁱ

It would seem that **the increase in inequality within countries is not related to the degree to which the country embraces market fundamentalism** (alternatively the level of government intervention in an economy) – as the zero correlation with economic freedom suggests. Instead it is feasible that over the long term an increase in GDP per capita leads to greater equality via some unknown mechanism not related to either market fundamentalism or government action.

Perhaps technologically driven increases in productivity or greater equality in skill development lead to the greater equity that comes with higher national incomes.

4. **The way the report portrays wealth inequality is misleading.** It is not difficult for the wealthiest two people in South Africa to have the same wealth as the bottom half of the population when most people don't acquire net property until well advanced in age. Even in developed countries on the order of 40% of adults have no wealth at all and are likely to have a negative net wealth.
5. There is **almost unanimous disagreement among elite economists with Piketty's thesis** that returns to wealth exceeding growth is driving inequality in the US and Europe. A survey of economic experts (most of whom are ideologically well to the left of the general population) showed that only 3% agreed and 81% disagreed.^{iv} The DTC itself notes that Krugman also disagrees and proposes a different explanation.^v Many economists also suggest that his proposed wealth tax coordinated internationally has no hope of being established.
6. In the same survey of economists mentioned above 88% endorsed (only 4% rejected) **technological change favouring the skills of some over others as the main driver of inequality.** If so then recent increases in inequality within countries is very plausibly a temporary phenomenon.^{vi}
7. Apart from the finding in point 2 that cross sectional redistribution has no effect on lifetime income inequality, a randomised control study of **wealth redistribution** (the Georgia Land Lottery of 1832) found it **had no effect on the wealth, education and welfare of the descendants of the poorest third of the population** who qualified for the lottery. This is **not consistent with the view that poverty is due to a lack of assets.**^{vii}
8. **Inequality is a red herring.** The important issue is how poor those at the bottom are and not how much richer those at the top are. Some suggest that the poor are poor because the rich are rich but there is no convincing causal relationship between inequality per se and poverty theoretically or empirically. Stiglitz claims inequality leads to slower growth and that greater equality will speed up growth but Krugman (and most economists) disagree.
9. In point 3 above the point was made that inequality (and more pertinently poverty) seems to drop over the long term when countries become wealthier. In points 2, 3 and 7 the point was made that **redistribution is an ineffective means to reduce lifetime poverty.**
10. Addressing inequality directly runs the substantial risk of distracting South Africa from effectively tackling poverty. Therefore **instead of considering what effect different tax regimes will have on cross sectional redistribution, the DTC should consider which tax regimes most help (or least hinder) investment, business and job creation.** Many prominent economists are of the opinion that wealth taxes are likely to reduce savings and investment of those with the means to do so and therefore hamper business and job creation. If so it is plausible that wealth taxes and redistribution may actually exacerbate poverty. The DTC committee should at least consider that possibility.

11. Some forms of tax distort economic activity far more than others. There is widespread agreement among economists that consumption taxes are the least distortionary. On the other hand there is vigorous disagreement on taxes on capital. A large proportion of economists believe taxes on capital are so bad they should be dropped altogether. In light of this diversity of opinion the DTC seems highly overconfident about the causes of poverty and inequality and even more so about the effectiveness and harmlessness of its recommendations.
12. While the recent recession may be due to a lack of demand following the financial crisis it does not follow that there is still a demand shortfall that can be plugged by redistribution or other means to stimulate growth. Furthermore while a stimulus may be wise during a recession driven by a lack of demand it is not wise during normal economic circumstances or during supply side recessions. The argument that higher wealth taxes will stimulate growth via redistributing it to the poor who are more likely to spend it is thus questionable. Where there is not a recession driven by a demand shortfall it is likely to lead to inflation instead of growth. Since recessions are short term, a policy of stimulus via estate taxes is counterproductive long term. In any case the amount of stimulus that could be generated that way is way too small and probably inefficient.

The fairness of estate taxes

The DTC states that wealth taxes are equitable and that repealing them are likely to be seen as inequitable. However the report also mentions the Katz Commission saying that vertical equity involves values judgements about which there is much disagreement. There are no doubt many who do think wealth or progressive taxes are equitable but there are also many who think the opposite.

Some reasons why estate taxes may be seen as unfair:

- **Estate taxes are double taxation.** Here I am not referring to the combination of CGT and estate duties but to the fact that assets are typically purchased with after tax income so death taxes clearly qualify as double taxation.^{viii}
- **It is unfair to over-tax individuals for building a nest egg.** Harvard economist Greg Mankiw, November 4th, 2003. "Consider the story of twin brothers – Spendthrift Sam and Frugal Frank. Each starts a dot.com after college and sells the business a few years after, accumulating a \$10 million nest egg. Sam then lives the high life, enjoying expensive vacations and throwing lavish parties. Frank meanwhile, lives more modestly. He keeps his fortune invested in the economy, where it finances capital accumulation, new technologies, and economic growth. He wants to leave most of his money to his children, grandchildren, nephews, and nieces. Now ask yourself: Which millionaire should pay higher taxes? What principle of social justice says that Frank should be penalised for his frugality? None that I know of."

Another problem with estate duties:

- It is claimed that the **cost of compliance** with estate duties is so high that it equals or **exceeds the revenue gained** therefrom.

Declining revenues from wealth taxes

The DTC report claims that revenues from estate duties and donations taxes are declining. If you look at their Figure 3^{ix} which they use to illustrate this there isn't a steady decline from the peak to the present. Instead there is a very large drop in estate duty/donations tax revenues between 1985/86 and 1989/90. There was a change from a progressive rate to a flat rate in the middle of this decline which had no effect on the trend.

Since 1992/93 there has been a long term trend of increasing real term revenues from estate duties and donations taxes. During this increase the introduction of CGT in 2001 and the increase in rebate in 2006 also had no effect on the trend. The extent of this increase is large. During those 14 years the real revenues have more than tripled or increased at an annual rate of 8%. The real returns have flattened since 2007 – most likely due to the financial crisis but has started to increase again and is expected to continue to increase.

The lack of change in the real revenue trend in response to changes in duties and taxes suggests that changes recommended by the DTC might also have no effect.

The DTC goal of much higher wealth tax revenues

In assessing the wealth tax collection potential of South Africa the DTC compares RSA figures to a range of advanced economies. This is a **wholly inappropriate reference group** of countries. They have a much larger proportion of very wealthy individuals than does South Africa so they have a much larger base to tax. Aspiring to their levels of wealth tax collection is unrealistic.

Recommendations to DTC

1. **Reconsider the wisdom of not repealing estate duties and donations taxes.** There are arguments that they aren't in fact equitable or fair, evidence that they do nothing to combat lifetime inequality or poverty and there are arguments that they may be a net harm through reducing savings and investment and also in high cost of compliance.
2. If the DTC still decides to not recommend repealing wealth taxes completely it **will** be worthwhile to **reduce the estate duty/donations tax rates**. The DTC argues that the effective rate is below the 15% rate above which international experience suggests results in extreme avoidance and evasion measures for most payers of estate duties.

However the word 'extreme' implies that there are already substantial avoidance and evasion measures at rates below 15%. The report refers several times to the large unproductive estate planning industry. A reduction in rate, in addition to the increase in primary abatement, would help to reduce the extent of avoidance. It would also be fairer.

3. Don't expect a lot more revenue. The real revenues from wealth taxes and CGT are likely to increase – due to the underlying trend and perhaps loophole closing – but not anywhere near 10-15 fold. The overall contribution to revenues is likely to remain disappointing.

Garth Zietsman
Consultant to FMF

The Free Market Foundation

The Free Market Foundation (FMF) is an independent non-profit public benefit organisation founded in 1975 to promote and foster an open society, the rule of law, personal liberty, and economic and press freedom as fundamental components of its advocacy of human rights and democracy based on classical liberal principles. It is financed by membership subscriptions, donations and sponsorships.

Most of the work of the FMF is devoted to promoting economic freedom as the empirically best policy for bringing about economic growth, wealth creation, employment, poverty reduction and human welfare. As a think-tank the FMF's fundamental approach to policy questions is consumer-based. Individual consumer choice is placed at the centre of any policy recommendations that the FMF espouses. Consumer satisfaction is generally achieved by an absence of barriers to entry into the provision of goods and services, allowing consumers a choice between the offerings of freely competing providers, and the absence of regulations that impose avoidable costly burdens on the providers of goods and services.

-
- i Redistribution from a lifetime perspective. Levell P., Roantree B. & Shaw J. ISF Working Paper (W15/27). www.ifs.org.uk/publications/7986
 - ii Economic Freedom of the World Reports and World Bank data.
 - iii p 14 of the DTC First Interim Report on Estate Duty for the Minister of Finance.
 - iv Piketty on Inequality. IGM Forum. Oct 14, 2014. <http://www.igmchicago.org/igm-economic-experts-panel>
 - v p 18 of the DTC First Interim Report on Estate Duty for the Minister of Finance.
 - vi Inequality and skills. IGM Forum. Jan 24, 2012. <http://www.igmchicago.org/igm-economic-experts-panel>
 - vii Up from Poverty: The 1832 Cherokee Land Lottery and the long run distribution of wealth. Bleakley H. & Ferrie J. https://docs.google.com/viewer?url=https://www.sss.ias.edu/files/pdfs/Rodrik/workshop%2014-15/Bleakley_Ferrie_Up.pdf
 - viii <http://www.heritage.org/research/reports/2003/03/protecting-seniors-from-double-taxation>
 - ix p 28 of the DTC First Interim Report on Estate Duty for the Minister of Finance.