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Strengthening the tax  
system to reduce  
inequalities and increase  
revenues in South Africa

**Falilou Fall**

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**ECONOMICS DEPARTMENT**

**STRENGTHENING THE TAX SYSTEM TO REDUCE INEQUALITIES AND INCREASE REVENUES IN SOUTH AFRICA**

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By Falilou Fall

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## Abstract/Resumé

### ***Strengthening the tax system to reduce inequalities and increase revenues in South Africa***

The Covid-19 crisis has exacerbated the already deteriorating fiscal situation in South Africa. The current consolidation strategy, based on spending cuts and reprioritisation of spending items, has reached its limits and is insufficient to stabilise the debt ratio in the medium term and fund unmet public services needs. The tax-benefit system needs to be redesigned to create fiscal space in the years to come to finance growth-enhancing reforms and to reduce inequalities. The challenge is to generate additional revenues without generating inefficiencies or exacerbating inequality. Income taxes represent around half of total tax revenues, but are levied on small tax bases, partly reflecting the unequal distribution of income. Only the value-added tax has a relatively broad basis combined with a moderate tax rate. There is some scope to raise revenues further while reducing existing tax distortions, notably by broadening the base of corporate and personal income taxes, as well as consumption taxes. Taxes with a less harmful impact on growth, such as property taxes, are limited by the inefficient municipal rates system. There remains scope to further increase environmentally-related taxes.

*JEL codes : H23, H24, H25, H26, H27*

*Key words: Tax, Personal Income tax, Business tax, Goods and services tax, Government revenues*

This Working Paper relates to the 2022 OECD Economic Survey of South Africa.

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### ***Renforcer le système fiscal pour réduire les inégalités et augmenter les recettes en Afrique du Sud***

La crise Covid-19 a exacerbé la situation budgétaire déjà dégradée de l'Afrique du Sud. La stratégie d'assainissement actuelle, fondée sur la réduction des dépenses et la redéfinition des priorités, a atteint ses limites et ne suffit pas à stabiliser le ratio d'endettement à moyen terme et à financer les besoins non satisfaits en matière de services publics. Le système d'imposition et de prestations doit être repensé afin de créer une marge de manœuvre budgétaire dans les années à venir pour financer les réformes favorables à la croissance et réduire les inégalités. Le défi consiste à générer des recettes supplémentaires sans générer d'inefficacités ni exacerber les inégalités. L'impôt sur le revenu représente environ la moitié des recettes fiscales totales, mais il est prélevé sur de petites assiettes fiscales, ce qui reflète en partie la répartition inégale des revenus. Seule la taxe sur la valeur ajoutée a une base relativement large combinée à un taux d'imposition modéré. Il est possible d'augmenter encore les recettes tout en réduisant les distorsions fiscales existantes, notamment en élargissant l'assiette de l'impôt sur les sociétés et sur le revenu des personnes physiques, ainsi que des taxes sur la consommation. Les impôts ayant un impact moins néfaste sur la croissance, tels que les impôts fonciers, sont limités par le système inefficace des taux municipaux. Il reste possible d'augmenter encore les taxes liées à l'environnement.

*Codes JEL: H23, H24, H25, H26, H27*

*Mots clés : Taxation, Impôt sur le revenu des personnes, Imposition des entreprises, Taxation des biens et services, Revenu du gouvernement*

Ce Document de travail a trait à l'Étude économique de l'OCDE d'Afrique du Sud.

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# Strengthening the tax system to reduce inequalities and increase revenues in South Africa

Falilou Fall<sup>1</sup>

## Introduction

The Covid-19 crisis has exacerbated the already deteriorating fiscal situation in South Africa. The current consolidation strategy, based on spending cuts and reprioritisation of spending items, has reached its limits and is insufficient to stabilise the debt ratio in the medium term and fund unmet public services needs. The tax-benefit system needs to be redesigned to create fiscal space in the years to come to finance growth-enhancing reforms and to reduce inequalities. The challenge is to generate additional revenues without generating inefficiencies or exacerbating inequality. Income taxes represent around half of total tax revenues, but are levied on small tax bases, partly reflecting the unequal distribution of income. Only the value-added tax has a relatively broad basis combined with a moderate tax rate. There is some scope to raise revenues further while reducing existing tax distortions, notably by broadening the base of corporate and personal income taxes, as well as consumption taxes. Taxes with a less harmful impact on growth, such as property taxes, are limited by the inefficient municipal rates system. There remains scope to further increase environmentally-related taxes.

South Africa's debt trajectory will not be sustainable without higher growth, limited increases of spending and higher revenues for the government. Gross debt rose steadily over the last decade and accelerated during the crisis (Figure 1, Panel A). Debt service costs continued to increase as a consequence both of growing debt-to-GDP and rising interest costs (Figure 1, Panel B). Even a primary surplus of 1% of GDP over the next ten years would not stabilise the debt-to-GDP ratio, given low growth prospects and expected borrowing interest rate levels.

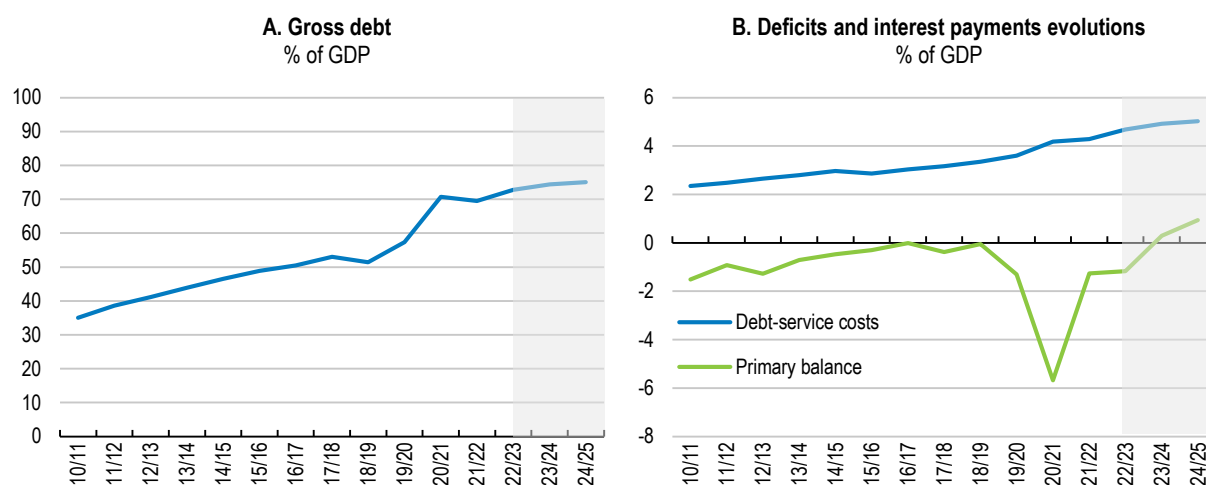
Spending pressures remain high, notably for infrastructure projects and the planned national health insurance scheme and social transfers for unemployed individuals. To enhance fiscal sustainability, the National Treasury's strategy focuses on improving spending efficiency by reducing waste and corruption. This strategy is a step in the right direction. Tangible improvements in public sector spending efficiency might contribute to raising compliance levels and make tax changes more socially acceptable. Nonetheless, additional measures are needed to create the required fiscal space to finance growth-enhancing reforms. This paper explores potential directions for a tax reform that would simultaneously

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raise the effectiveness of tax collection, while reducing income inequality and existing growth distortions in the tax system.

**Figure 1. The budget situation has worsened**



Source: National Treasury, Budget Review 2022.

## The challenges of a tax reform

### *Tax revenues remain stable but are slightly tilted toward direct taxes*

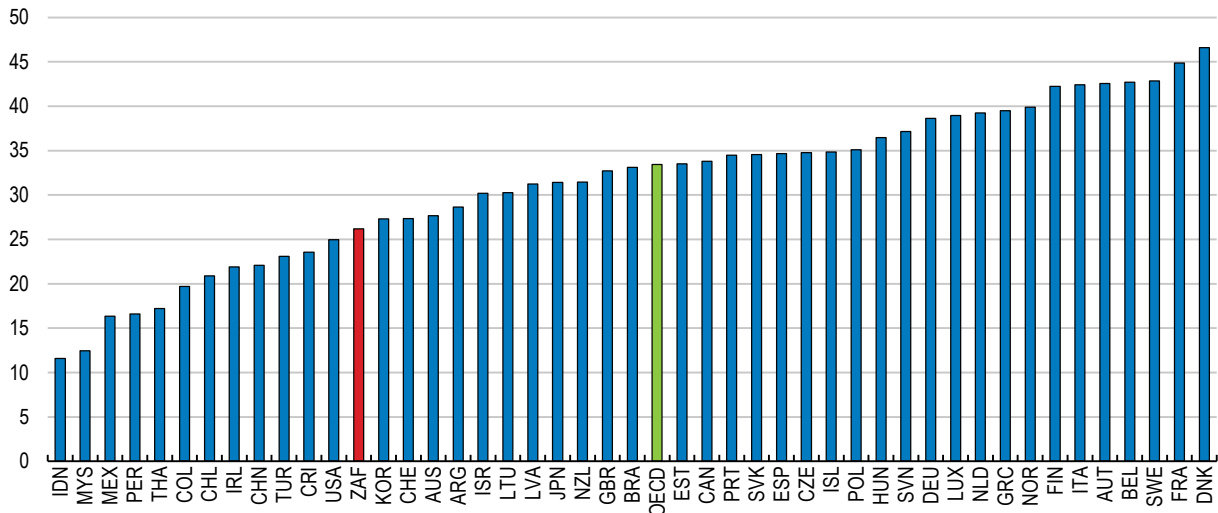
Government revenues, at 26% of GDP in 2019, are lower than the OECD average, but higher than most emerging market countries (Figure 2). Like for many other countries, government revenues fell sharply in the fiscal year 2020/21 due to the Covid-19 pandemic. The boom in commodity prices is temporarily boosting fiscal revenues and creating fiscal space to finance spending related to the pandemic among other priorities.

Taxation is relatively balanced between direct and indirect taxes. Direct taxation of individuals and firms represents 60% of government revenues. However, social security contributions and payroll-based contributions are low: government health care spending and social transfers are financed out of the national budget and only a 2% contribution rate is levied on wages for unemployment insurance (Figure 3). Taxes influence economic agent's decisions. For households, the tax system influences work, consumption, and savings. For firms, it changes the relative cost of labour and capital. This has an impact on hiring, investment, innovation and profit distribution decisions of firms. South Africa may consider rebalancing its taxation structure toward more indirect taxation (consumption and property taxes) as they appear broader and less harmful to employment than direct taxes.



**Figure 2. The Tax-to-GDP ratio is below the OECD average but higher than in most other emerging countries**

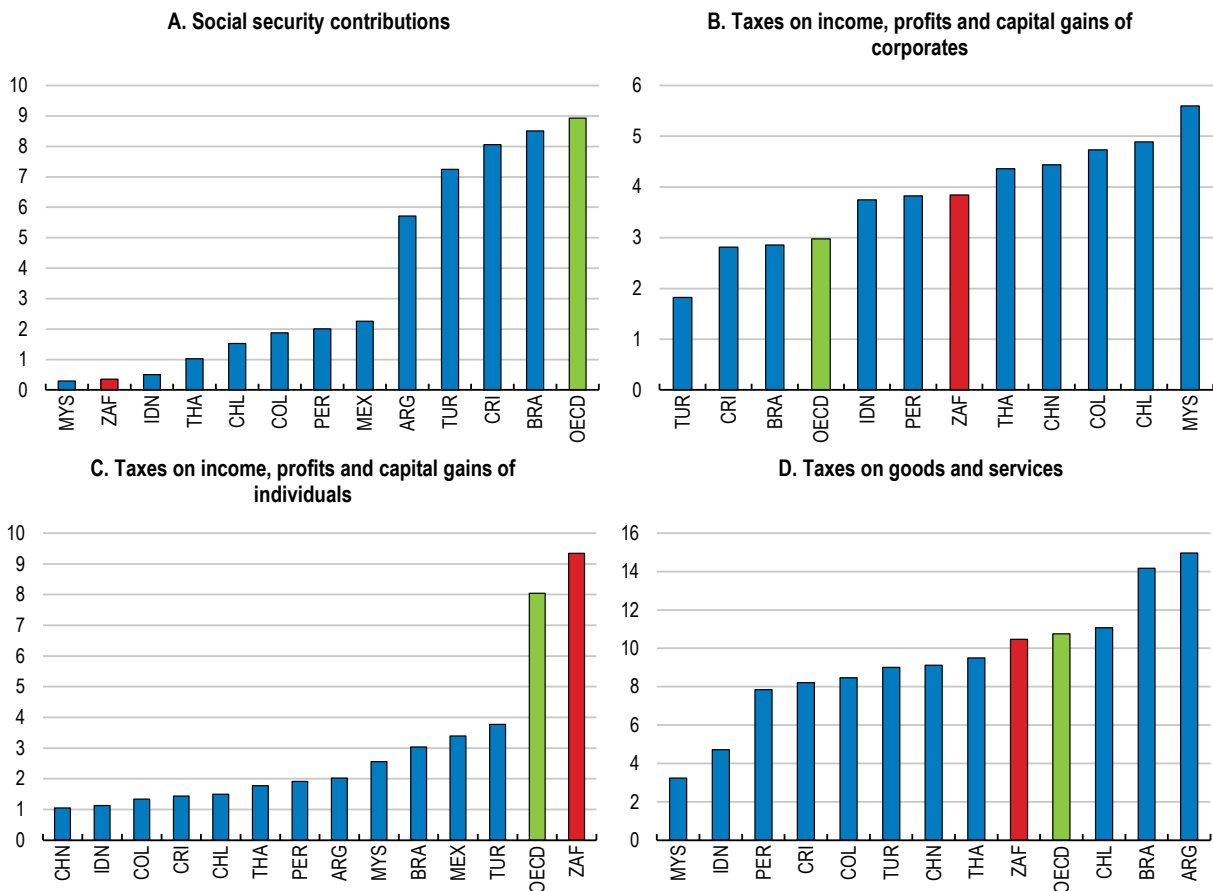
Government revenue as a % of GDP, 2019



Source: OECD Tax database.

**Figure 3. The tax structure is tilted toward direct taxation**

% of GDP, 2019



Source: OECD Tax database.



In addition to a standard corporate tax with a rate of 28% (the government plans to reduce it to 27%), South Africa has two business tax regimes targeted at small businesses: a microbusiness regime (with low rates on turn over) and a small business corporations' tax (with a progressive tax rate schedule). These regimes are reviewed in the following sections and ways to improve their effectiveness are analysed, in particular, as part of a reform that aims at reducing the corporate income tax rate by broadening the tax base.

Consumption taxes are more growth-friendly in the long-term but can have short-term effects on inequality that should be offset in other ways. There is also room to increase consumption tax rates, compensated by grant transfers toward low-income households. Recurrent taxes on immovable property are also theoretically more growth-friendly and, depending on their design, can be equity-enhancing. Property taxes are mostly set by local governments in South Africa. Property taxes remain limited, while wealth inequality is the highest in the world. Wealth taxation could be increased by broadening the tax basis and increasing the taxation of donations and estate duties. Finally, gradually increasing the carbon tax rate and broadening its base would reduce the carbon intensity of the economy.

The following sections identify ways to make the tax system less distortive, increase government revenues directly but also indirectly through higher growth and reduce inequalities. Overall, priority should be given to reforms that broaden tax bases, as a more growth-oriented way of raising tax revenues than increasing tax rates (OECD, 2010).

## Broadening the personal income tax base would improve its progressivity

### *The base of the personal income tax system is narrow*

Taxes on personal income are the most important source of revenue. South Africa has been more successful than many other middle-income countries in covering its population by the tax system. This is explained by an efficient registration system, with a long history. Still, only about 52% percent of the working-age population is registered, which is a consequence of the low labour force participation rate of 54% . Informality of firms and of workers also reduces tax bases; informal employment, at 32%, although high, is generally considered to be small relative to other emerging economies (ILO, 2018).

The personal income tax base is narrow. In 2020, the number of taxpayers was 5.2 million compared to 11.3 million employees in the formal sector. Different factors contribute to this narrow tax base. Half of workers are earning below or around the minimum wage and, therefore, their revenue is below the minimum tax threshold. Also, the minimum tax threshold is relatively high; it corresponds to about 20% of average earnings in 2019, which is around the OECD average (Figure 5, Panel A). It is, however, high for South Africa, as the average income is high, positioned at the 8<sup>th</sup> decile of the income distribution, due to a highly skewed wage income distribution.

The minimum income tax threshold decreased in real terms recently as it has been uprated below inflation between 2016 and 2020, which increased the number of taxpayers (Figure 6). As the top marginal rate was increased from 41% to 45%, options could be considered to broaden the tax base from below as an integral part of a reform that broadens the tax base for higher income earners. Slightly lowering the minimum income tax threshold would include some individuals earning between the minimum wage and the current income tax threshold. (Figure 5, Panel C).

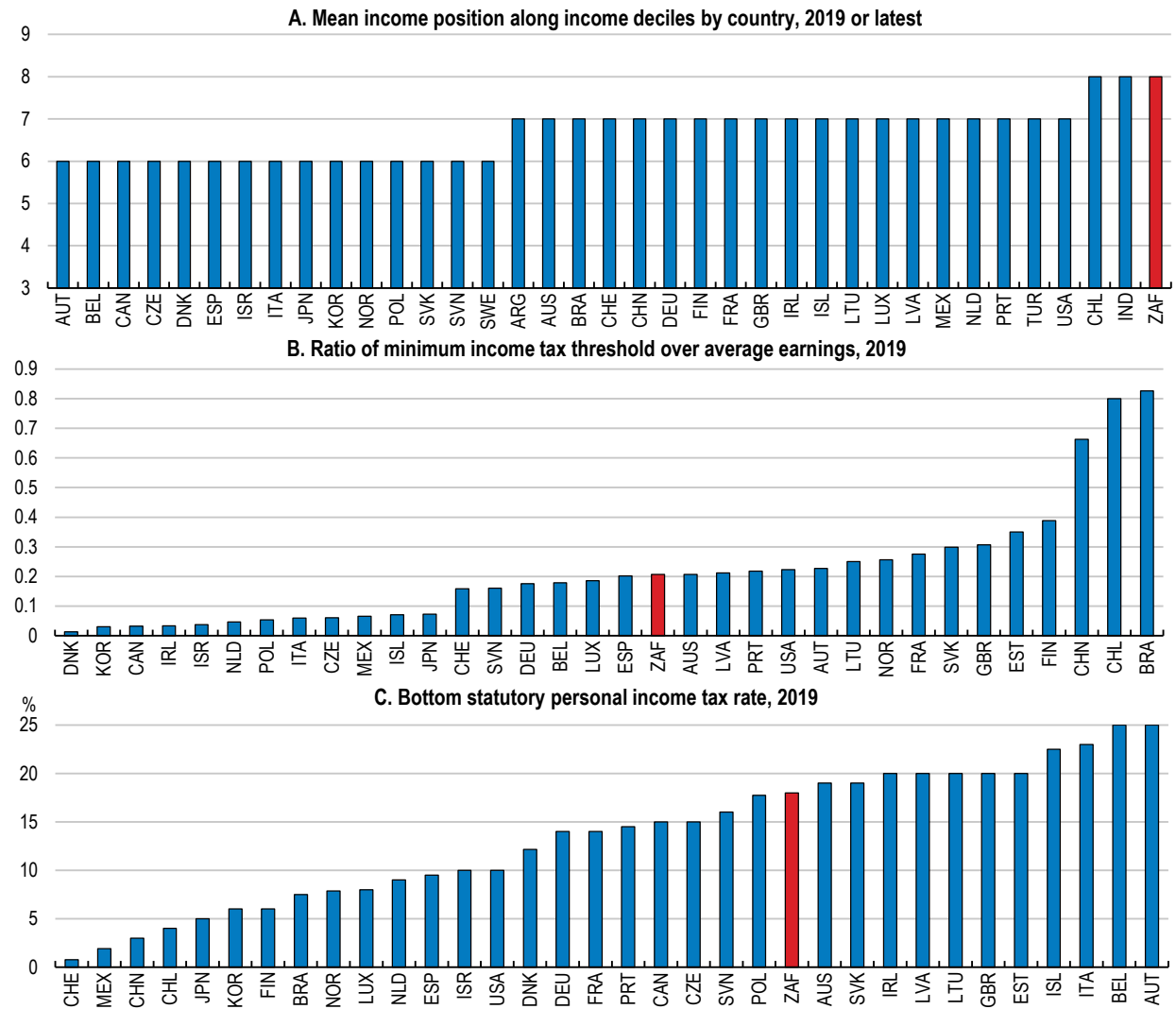
Moreover, the taxation, under different regimes, of certain capital incomes affects the personal income tax base. Types of income taxable under the personal income tax include mainly all types of income from employment such as wages, bonuses, overtime pay, taxable benefits (fringe benefits) and allowances, representing around 78% of taxable income in 2019. Also, certain categories of revenues as income from a business (trade, profits arising from a trust beneficiary; etc.), investment income (capital gains, interest, foreign dividends, rental income, etc.) and retirement income (annuities, pensions) are taxed under the personal income tax.

A significant share of realised capital gains is not included in the personal income tax base. Starting from October 2001, taxable capital gains are determined by deducting an annual exclusion amount of ZAR 40 000 and by applying after the deduction a 40% inclusion rate. While these tax provisions take into account the impact of inflation on asset values and the fact that the return on equity has been taxed already by the corporate income tax, the tax exemption seems large, and scope might exist to reduce it somewhat.

Except certain foreign dividends not covered by various exemptions, dividends are excluded from personal income tax, but are taxed at 20% since 2017. The dividends tax was introduced in 2012 at a rate of 15% to replace the Secondary tax on companies of 10%, which was also a tax on dividends but borne by the company. The dividends tax is a withholding tax paid by the company or the regulated intermediary. The effective tax burden on dividends, when considering the standard corporate income tax rate and the dividend tax rate, is 42.4 per cent, which is below the top PIT rate. Scope therefore exists to somewhat increase the dividend tax rate.

Interest received by an individual is taxable personal income. However, an exemption applies to the first ZAR 23,800 of local interest income (ZAR 34,500 for taxpayers who are 65 years of age or older). In 2019 almost 339 000 individual taxpayers earned local interest income that exceeded the interest exemption limit, amounting to an increase in taxable personal income of ZAR 28.9 billion (2% of total taxable income assessed; SARS, 2021).

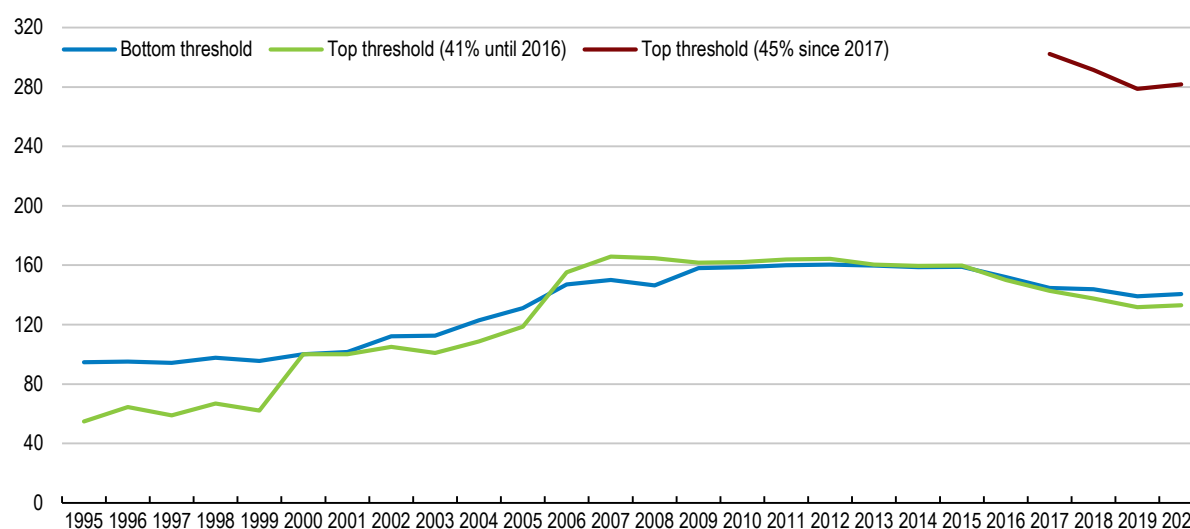
Figure 5. The minimum income tax threshold is high as the mean income is high



Source: OECD Income Distribution Database; OECD Taxing Wages 2020; OECD Tax Database; South Africa Revenue Service; KPMG and Instituto Brasileiro de Geografia e Estatística - IBGE; National Bureau of Statistics of China; OECD calculations.

**Figure 6. Tax thresholds have been lowered in real terms**

Tax thresholds in real terms, index 2000 = 100



Note: Thresholds are deflated by the CPI for urban areas. Data are for personal income tax years, which begin on 1 March of year shown. The top marginal income tax rate had been 40-41% between 1 March 2014 and 28 February 2017. Since 1 March 2017, in addition to the 41% tax rate, the top marginal income tax rate was redefined to be 45%. Its taxable income threshold in real terms is presented in a separate line, and is benchmarked against the top threshold in 2000.

Source: National Treasury and South African Revenue Service Tax Statistics; OECD Consumer price indices - Complete database; OECD calculations.

### ***Increasing the progressivity of the personal income tax schedule to reduce income inequalities***

Successive reforms over the last two decades have simplified the tax structure, reduced the number of tax brackets, and broadened the tax base by taxing fringe benefits and capital gains. In 2019/20, all tax thresholds have been frozen to increase government revenues. In 2017/18, an additional bracket with a marginal tax rate at 45% for revenues above ZAR 1.5 million was introduced, further reinforcing the progressivity of the tax rate schedule.

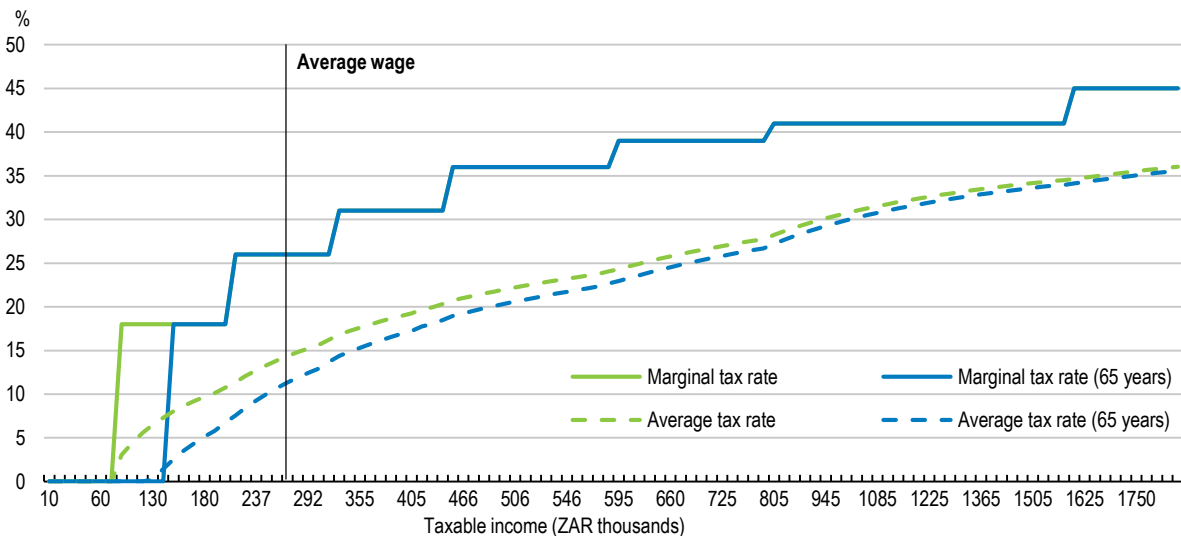
The design of the tax schedule is progressive. The combination of a basic tax allowance and increasing marginal tax rates ensures that the average statutory tax rate rises with income (Figure 7Figure ). The personal income tax system raises a much higher share of revenues from the richest households than in other emerging economies (World Bank, 2014). However, the revenue-raising capacity of the tax schedule is limited by the highly unequal income distribution and, in particular, because a large share of taxpayers earns little income. The taxable income of the top 20% of income earners represented more than 50% of total taxable income in 2019 (Figure 8). Therefore, the after-tax income inequality remains high as a result of the skewed market income distribution.

Tax allowances and deductions reduce the effective tax rate and undermine the progressivity of the tax schedule as higher income-earners end up facing lower effective tax rates than middle-income earners (Figure 9, Panel A). Tax allowances comprise travel and subsistence allowances, share options exercised and allowances covering savings and equity instruments (other allowances). The travel allowance is the biggest tax allowance, representing 26% of allowances in 2019, and 80% of the travel allowance is tax deductible. Tax allowances represent 21% of collected personal income tax in 2019 and about 7% of taxable income. Fringe benefits as the acquisition of asset at less than the actual value, right of use of motor vehicle, free or cheap residential accommodation, and medical aid paid on behalf of employee and pension and provident fund, among others, are benefits for employees born by the employer. While fringe

benefits are included in the PIT base, they are often undervalued for tax purposes. Scope exists to increase the value that is included within the PIT base of the fringe benefits the individual has received.

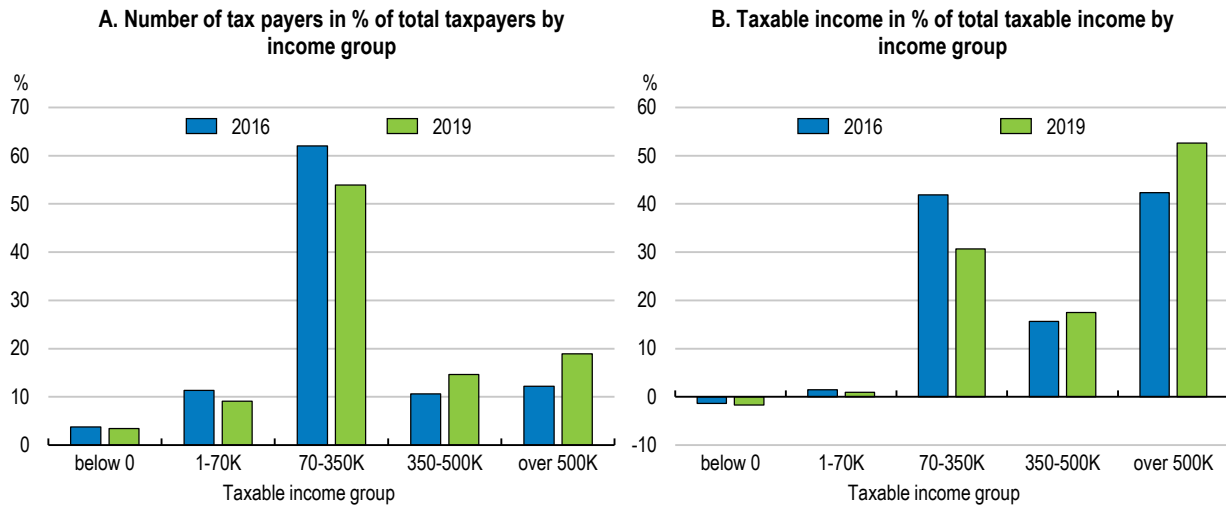
Deductions represented around 12% of personal taxable income and 41% of personal income tax collected in 2019. Deductions for retirement savings, 85% of total deductions, explain the biggest share. The 2016 reform of incentives for retirement savings harmonised the tax treatment of different saving schemes and introduced a nominal cap on tax-deductible contributions (ZAR 350 000), thereby reducing tax-planning opportunities that disproportionately benefited high-income earners. Nonetheless, such deductions continue to mostly benefit middle- and high-income earners (Figure 9). While having levelled the playing field, the introduction of an annual cap on deductible contributions (the lowest value between ZAR 350 000 and 27.5% of the highest between remuneration and taxable income) has increased the amount of deductions that many taxpayers can benefit from. Provident fund members benefit from a tax deduction on contributions made to their provident fund and see an increase in their take-home pay as they now receive a tax deduction for their contributions. All in all, the reform has increased pension contribution deductions. The amount of deductions awarded for pension savings vehicles should be revised when some of those savings are withdrawn before retirement as such savings will not support pension anymore. These early withdrawals could be partly or entirely subject to a tax in line with other personal income. Moreover, taxpayers aged over 65 and 75 years receive additional tax relief in particular a secondary and tertiary rebate on income tax. This tax relief for pensioners is redundant with the tax deductions for pension savings. Also, it breaks the fairness of the tax system between workers and aged taxpayers and will have a growing fiscal cost as population ages. The tax relief for pensioners should therefore be phased out.

**Figure 7. The personal income tax schedule is progressive**



Source: OECD calculations.

**Figure 8. The tax base reflects the highly unequal income distribution**

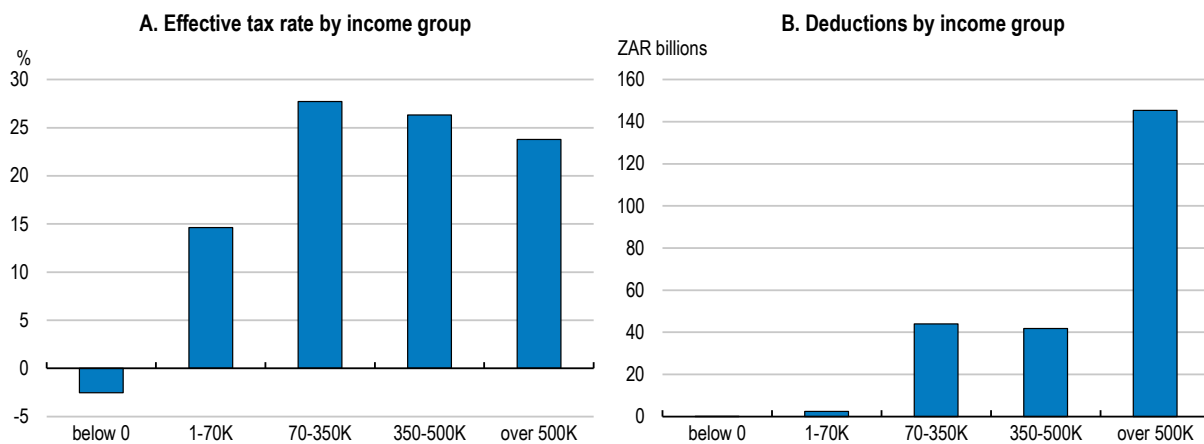


Source: South African Revenue Service, Tax Statistics 2021; OECD calculations.

Medical tax deductions (around ZAR 40 billion) are large and reduce the progressivity of the tax schedule. Medical tax credit rebates alone amounted to around ZAR 24 billion in 2019. These medical tax credits increase incentives to purchase private medical insurance. South Africa spends around 8.1% of GDP on health, half from the public sector and the other half from the private health sector, which covers only 16% of the population. The government intends to roll out progressively a national health insurance (NHI) system, offering a large basket of health benefits including primary care, emergency and hospital-based services. As the national health insurance system is deployed, the medical tax credit rebates and deductions could be reduced progressively to finance the NHI (OECD Economic Survey, 2020a). Reducing tax deductions and allowances and taxing fringe benefits more adequately would restore the progressivity of the PIT system and contribute to inequality reduction.

**Figure 9. Tax deductions benefit mostly high-income earners**

Taxable income in 2019



Note: The 350-500K category is likely biased as it bundles two income tax brackets with different PIT rate. The data do not allow to separate them.

Source: South African Revenue Service, Tax Statistics, 2021; OECD calculations.



### ***Income tax, transfers, and participation to the labour market***

Taxes levied on payroll are relatively low and are not a major barrier to job creation. Contributions to the unemployment insurance and the skill development fund are the only direct social contributions on wages. The unemployment insurance contribution rate is 2% of wages, equally paid by the employee and the employer. Contributions to the unemployment insurance are subject to a maximum earnings ceiling, which was ZAR 17 712 per month in 2021 (around 5 times the minimum wage). A skill development levy on payroll and wage benefits is imposed, collecting 1% of the total amount paid in salaries to employees (including overtime payments, leave pay, bonuses, commissions and lump-sum payments). The revenues from the skill development levy serve to encourage learning and development. Therefore, income taxes on wages are the only other direct tax for wage earners. South Africa's tax wedge is relatively low, and this is likely to be a minor barrier to job creation, at least for the household types considered in the analysis below (see Table 1).

The social transfer system is broad and well-functioning (OECD South Africa Economic survey 2020a). Around 18.2 million out of 57 million South Africans now receive social grants – the majority of which are for children and the elderly. Unemployed working age people are not covered by the social assistance system, while mothers of children receive a relatively low child support (ZAR 450) when compared to the national minimum wage (around ZAR 3 800 per month in 2021). Such level of transfer is not likely to be a direct barrier to labour force participation, although the low amount might prevent parents from paying for childcare and thus, indirectly, may prevent parents and in particular women from entering the labour market. Transport costs are a higher barrier to employment than the lower labour market participation risk some associated with social transfers.

The tax schedule is probably not a major barrier to labour force participation either. The gap between formal employment earnings and social assistance benefits is huge, in particular for earnings above the average income level. Therefore, increasing marginal income taxes above the average wage should not affect labour participation significantly. To increase labour participation, an in-work tax credit for low-income earners could be considered as a complement to the current wage subsidy that mainly targets youth employment. A tax credit should particularly benefit low-skilled workers and would also reduce rates of in-work poverty, as seen in other countries with highly unequal income distributions, such as the United States. However, an in-work tax credit would not address the labour demand dimension. But it could also encourage informal workers to move into the formal sector and help to offset the high costs of commuting faced by many low-income workers.

**Table 1. Average and marginal tax wedges are relatively low**

As % of labour costs, by household type and wage level.

	Average tax wedge			Marginal tax wedge		
	At:					
	67%	100%	167%	67%	100%	167%
no children						
	of the average wage			of the average wage		
OECD average	30.6	34.6	39.0	40.3	43.8	45.7
Australia	23.3	28.4	34.7	39.6	45.3	42.4
Chile	7.0	7.0	8.3	7.0	10.2	10.2
Denmark	32.4	35.2	40.8	38.7	41.7	55.5
Hungary	43.6	43.6	43.6	43.6	43.6	43.6
Iceland	24.1	32.3	41.2	35.6	53.6	56.8
Mexico	16.5	20.2	23.2	17.5	25.2	28.4
Netherlands	29.0	36.4	41.5	17.5	30.0	33.0
New Zealand	14.0	19.1	24.5	17.5	30.0	33.0
Poland	34.1	34.8	35.4	36.3	36.3	36.3
Turkey	36.4	39.7	42.9	42.8	47.8	47.8
Brazil	31.8	32.5	36	31.8	32.5	42.9
China	34.9	30.7	30.8	22.1	22.1	32.4
India	24.8	26.5 (1)	5.6	24.8	24.8	4.5
Indonesia	7.8	7.8	7.8	7.8	7.8	7.8
South Africa	<b>12.8</b>	<b>16.9</b>	<b>22.6</b>	<b>18.8</b>	<b>26.7</b>	<b>36.6</b>

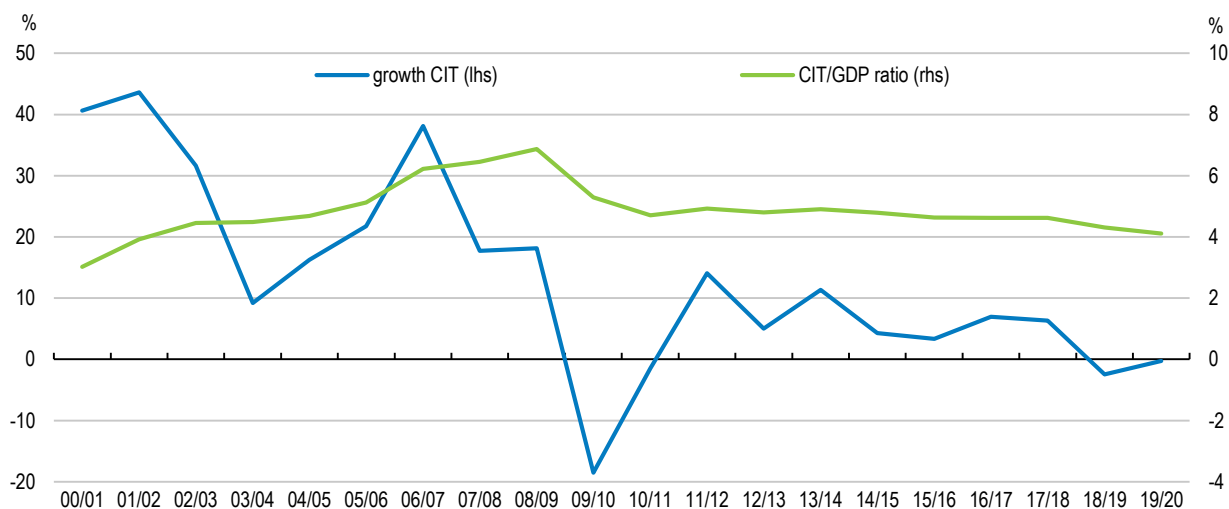
Note: Average tax wedge is the difference between total labour compensation paid by the employer and the net take-home pay of employees, as a share of total labour compensation. Marginal tax wedge is the difference between the change in compensation and take-home pay as a result of an extra unit of national currency of labour income, as a share of the change in total labour compensation. OECD countries with low social security contributions/payroll taxes are: Australia, Denmark, Iceland and New Zealand. Data are 2020 for OECD countries and 2019 for Brazil, China, India, Indonesia and South Africa. 2) For India, results apply only for the minority case where the employee works in a firm with more than 20 employees

Source: OECD Taxing Wages 2021; OECD Taxing Wages in Selected Partner Countries, 2021.

## Broadening the corporate income tax base to reduce the tax rate

### **Corporate income tax revenues and rate are relatively high**

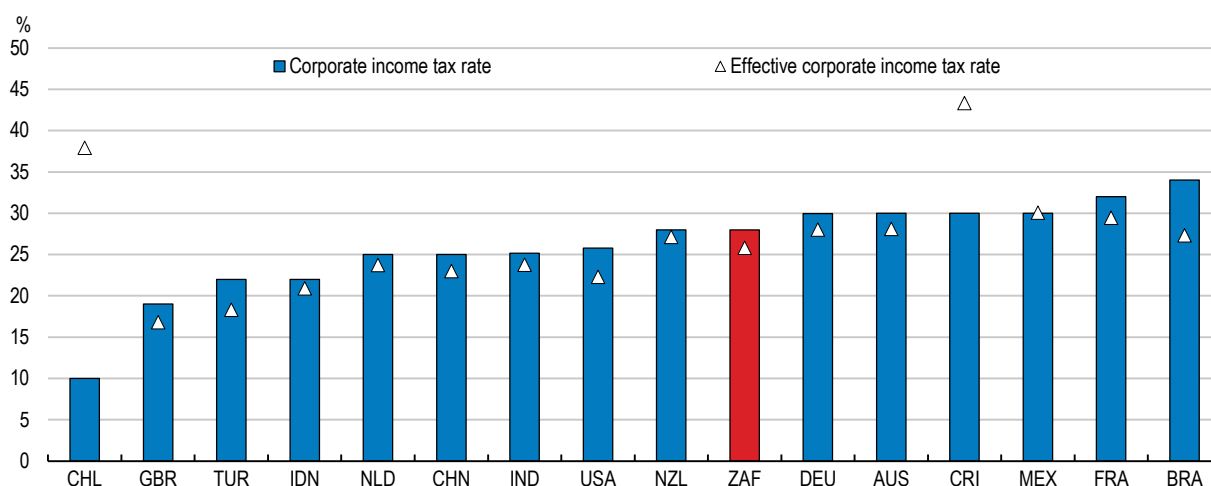
Tax collections from corporates are above the OECD average (Figure 3) and concentrated among large companies. Corporate income tax revenues are the third-largest source of government revenues, after taxes on individuals and goods and services. When taxes on dividends (secondary tax on companies) are included, corporate income taxes represented 18.9% and 17.7% of government revenues in 2018 and 2019, respectively. Corporate income tax revenues have been falling with GDP since the 2008 Global Financial Crisis (Figure 10). Moreover, the economy is highly concentrated, with few companies accounting for the bulk of corporate income tax revenues. Only 381 large companies (0.2% of the companies with positive taxable income) had a taxable income of more than ZAR 200 million in 2019 and were liable for 55.9% of the CIT (SARS, 2021).

**Figure 10. Corporate tax collection has been trending down since the 2008 Global Financial Crisis**

Note: Nominal growth of CIT.

Source: South Africa National Treasury, Budget Review 2021.

Since the fiscal year 2008/09, the corporate income tax (CIT) rate is levied at a rate of 28%. South Africa's CIT rate is slightly above the OECD average at 23%, but lower than many emerging market economies, such as Costa Rica, Brazil, India and Mexico (Figure 11). The corporate income tax is complemented by a withholding dividend tax of 20%. Dividends are taxed when distributed to individuals or firms, including foreign companies, depending on the provisions of double taxation treaties. In addition, capital gain is included in CIT taxable income at a rate of 80%. The fractional inclusion rate is meant to take into account the effect of inflation on capital gains.

**Figure 11. The corporate income tax rate is slightly above that in OECD countries**

Note: Data for 2020. The effective average tax rate reflects the average tax contribution a firm makes on an investment project earning above-zero economic profits. It is defined as the difference in the net present value (NPV) of pre-tax and post-tax economic profits relative to the NPV of pre-tax income net of real economic depreciation. See OECD Taxation Working Paper No. 38 (Hanappi, 2018).

Source: OECD Tax database.

### **Reducing tax deductions would allow reducing the headline tax rate**

South Africa could reduce its headline CIT rate and aim at offsetting the loss of revenues by broadening the tax base through stronger tax compliance and an improved design of certain tax deductions. The government plans to reduce the CIT rate to 27% in 2022. The corporate income tax gap is high in South Africa, i.e. the gap between what South Africa could theoretically collect and what it actually does (Jansen

et al., 2020). The CIT gap (compliance gap for the non-financial sector), as a percentage of the calculated potential current-year tax base, was close to 12% in 2017 as a result of tax evasion.

A company is able to carry forward assessed losses indefinitely, subject only to the requirement that the company continues to carry on trading. The total stock of losses that is carried forward and that have not yet been deducted from taxable profits is large (around 28% of GDP). Corporate tax expenditures in 2019 were around ZAR 20 billion. The government introduced an amendment in November 2021 to limit the amount of losses that can be deducted to 80% of taxable income. Consequently, a minimum of 20% of taxpayers' income is taxable each year – regardless of the amount of any assessed loss brought forward, which is a positive reform. In addition, the government could consider limiting to 8 years the duration of the carry forward of assessed losses.

Generous interest deductions can bias firms' behaviour towards the use of debt to finance investment as well as minimise tax liabilities. Multinational groups can use these deductions to optimise intra-group financing (OECD, 2017a). To address these tax optimisation risks, the OECD (2017a) recommended approach is a fixed ratio rule, which limits an entity's deduction of net interest to a percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA). As a minimum, this should apply to entities in multinational groups. A ratio between 10% and 30% is recommended. The government introduced an amendment proposing to limit interest deductions through a fixed-ratio limitation for net interest expense to 30% of earnings; and to restrict only connected-party interest rather than total interest (National Treasury, 2020b). The government proposal is in line with the OECD guidelines (2020b) and could be introduced once economic activity recovers from the COVID-19 crisis.

Overall, there is a trade-off between the relatively high headline rate of corporate income tax (28%) and the relatively narrow tax base given the different deductions and the tax gap. One point of corporate income tax collected on average ZAR 7.5 billion in 2019. Therefore, reducing the corporate income tax rate by 3 percentage points, for instance, would cost around ZAR 23 billion, which corresponds to base broadening measures of about ZAR 100 billion (ignoring any behavioural effects that base broadening measures may induce). Lower corporate income tax rates could help boost investment. Such a decrease would need to go hand in hand with a broadening of the tax base so as to not reduce overall corporate income tax revenues.

### ***Tax incentives and investment***

Tax incentives reduce tax liabilities and are not always effective in terms of attracting investment and creating jobs. Tax incentives are put in place to encourage local and foreign direct investment. World Bank (2016) analyses show that tax incentives have lowered the cost of capital for all sectors by between 3% and 6.5% and attracted higher investment in the agriculture, construction, manufacturing, trade and services sectors. Overall, the availability of tax incentives was estimated to have generated additional investment of about 2 billion dollars, representing approximately 1% of the capital stock in the long term. The additional investment resulted in approximately 34,000 additional jobs in 2012. More recent evaluations are needed. The cost of tax incentives increased to ZAR 27 billion in 2019 (Table 2).

The cost of creating jobs through the tax incentives are high; on average the yearly cost per job created was 116,000 rand. Overall, the World Bank assessment concluded that the tax incentives have mixed effects, depending on the sector. Tax incentives for Small Business Corporations that take the form of reduced corporate income tax rates (see below) were the least efficient in terms of additional investment and cost per additional job. The regime of capital depreciation for Small Business Corporations needs to be reviewed, reduced and harmonised with the regime of other sectors (Table 3). The overall system of incentives is also complex for firms to navigate, particularly for smaller firms, and transparency is reduced (and costs likely higher) for schemes that are administered by government departments.

The government's review of all tax expenditures, among which tax incentives, has revealed that many tax incentives do not result in additional investment. The 2021 Budget Review provides an estimation of the

foregone tax revenues of a wide range of corporate tax incentives (Table 2). As part of the results of this review, end dates were included for some tax incentives in 2020. A regular evaluation of the economic impact of tax incentives is needed, which in addition to the foregone revenues also measures the additional investment or jobs that have been created.

Venture capital funds are needed to replace the venture capital tax incentive. Taxpayers investing in a venture capital company were allowed an upfront deduction for their investment to encourage the establishment and growth of small, medium and micro enterprises. The National Treasury has determined that the incentive has not adequately achieved its objectives (National Treasury, 2021a). The incentive has instead provided a generous tax deduction to wealthy taxpayers and most support has gone to low-risk ventures that would have attracted funding without the incentive. The incentive was not extended beyond its sunset date of 30 June 2021. However, access to seed funding remains limited for start-ups and SMEs (OECD South Africa Economic Survey, 2017b). In 2017, through the CEO Initiative, the South Africa SME Fund was created, raising around ZAR 1.4 billion with contributions from about 50 firms and the Public Investment Company. The SA SME Fund provides funding to SMEs through market mechanisms and venture funds. The government could consider increasing its support to venture capital through the SA SME Fund.

**Table 2. Corporate income tax expenditures have been increasing**

In Rand million

	2016/17	2017/18	2018/19	2019/20
<b>Small business corporation tax savings</b>	3,114	3,198	3,127	2,633
<i>Reduced headline rate</i>	3,069	3,151	3,085	2,588
<i>Section 12E depreciation allowance</i>	44	47	42	45
Research and development	234	266	279	119
Learnership allowances	1,071	721	576	415
Strategic industrial projects (12I)	693	563	361	16
Film incentive	15	6	0	19
Urban development zones	277	318	307	325
Employment tax incentive	4,656	4,317	4,512	4,754
Energy-efficiency savings	1,223	608	1,913	120
<b>Total corporate income tax</b>	<b>16,827</b>	<b>18,380</b>	<b>27,334</b>	<b>12,572</b>

Source: National Treasury, Budget Review 2022.

Tax incentives for specific sectors or economic zones are often not successful. Many developing and emerging countries seek to attract capital investment by setting tax incentives in specific sectors or economic zones. These tax incentives come with different types of economic distortions. For instance, they can disadvantage local firms competing with foreign investors in a sector or direct investment into economic zones at the expense of other economic areas. Tax incentives also create windfall gains for firms that would have invested anyway. In South Africa, tax incentives for certain industries or economic zones take the form of accelerated capital depreciation (i.e. tax depreciation that is quicker than the economic depreciation of the asset, which constitutes a neutral tax treatment). Accelerated capital depreciation allowances are preferred to reduced rates or tax holidays in terms of optimal tax policy as they directly target investment expenses.

Overall, tax depreciation allowances vary widely across sectors, firm size and within special economic or urban development zones for the same type of capital, differing in terms of tax depreciation rates and length of depreciation (Table 3). Aligning the tax depreciation rules across sectors for the same type of capital would avoid tax-induced distortions. The government could consider reviewing the regimes of capital depreciation and defining a more neutral regime designed in terms of types of assets and their use rather than varying the tax depreciation treatment across sectors and firm sizes.

**Table 3. There are various special tax regimes for capital investment in 2021**

Target	Capital allowance treatment	Remarks
Manufacturing	Machinery and plant used in manufacturing activities: 40%, 20%, 20%, 20%.	.
Agriculture	Machinery and plant used in farming : 50%, 30%, 20%	
Mining	Machinery and plant used in mining: 100%	Ring fencing applies to 100% deduction, both in respect of mining income and on a per-mine basis.
Renewable energy	Machinery, plant and equipment for the production of biodiesel or bio-ethanol and the generation of electricity from wind, solar, hydropower or biomass: 50%, 30% 20%.	Machinery and plant for the production electricity for solar energy not exceeding 1 MW benefits from 100% allowance.
Special Economic Zones	Non-residential buildings erected within SEZs: 10% straight line	Industry carve outs and additional requirements apply.
Infrastructure and housing	Pipelines used for transporting natural oil, lines or cables used for the transmission of electronic communications: 10% straight line Low cost residential units: 10% straight line	A 5% straight line applies to pipelines, transmission lines and cables for other uses, as well as other types of residential units.
Small Business Corporations (SBC)	100% capital allowance of Plant and Machinery used in manufacturing; Capital allowance of Plant and Machinery of 50%, 30%, 20% for non-manufacturing activities.	SBCs are defined as corporations with gross income below a 20 million rand threshold and includes certain restrictions as provided under Section 12E of the Income Tax Act (1962).

Note: Table does not include incentives in the process of phase out (e.g. section 12I and section 13quat) or depreciation schedules considered part of the standard capital allowance treatment.

Source: Celani, A., L. Dressler and M. Wermelinger (2022), "Building an Investment Tax Incentives database: Methodology and initial findings for 36 developing countries", *OECD Working Papers on International Investment*, No. 2022/01, OECD Publishing, Paris,

### ***The new international two pillar tax and corporate taxation in South Africa***

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (IF) has agreed a two-pillar solution to address the tax challenges arising from the digitalisation of the economy (OECD, 2021a). The first pillar is designed to update the international tax rules for the digitalisation of the economy to ensure that MNEs pay taxes where they conduct sustained and significant business, even when they do not have a physical presence. Under the agreement, MNEs will pay more taxes where they sell their goods. The first pillar applies to multinational enterprises (MNEs) with global turnover above 20 billion euros and profitability above 10% (i.e. profit before tax/revenue) with the turnover threshold to be reduced to 10 billion euros contingent on successful implementation. Countries (jurisdictions) where these large MNEs derive at least 1 million euros in revenues will receive additional taxing rights. For smaller jurisdictions with GDP lower than 40 billion euros, the revenue threshold will be set at 250 000 euros (OECD, 2021a).

South Africa should benefit from the introduction of Pillar One as soon as MNEs make more than 1 million euros in revenue from the territory. Pillar One requires the removal of all digital service taxes and relevant similar measures on all companies. South Africa does not have a digital service tax, but has VAT on electronic services, which is a consumer indirect tax and therefore will not be affected by the removal of digital service taxes requirements.

Pillar Two introduces a minimum effective global corporate income tax set at 15%. The second pillar aims to impose multilaterally-agreed limits on tax competition by applying a top-up tax, using an effective tax rate test, to achieve a minimum effective direct tax rate across the globe of 15% (OECD, 2021a). Most South African firms would not be subject to the top-up rate as the effective corporate income tax rate, on average across firms of a particular size, is above 15% as far as their taxable income is positive and only a few South African companies will meet the revenue threshold requirement (Table 4). However, in some sectors, the percentage of firms reporting negative or zero taxable income is high. For instance, in mining and quarrying and in manufacturing only 32.3% and 40.5%, respectively, of firms reported a positive

taxable income in 2018 (SARS, 2020a). This is likely the result of generous tax incentives that could be affected by the new rule. However, the rule contains a substance-based carve out which may limit the impact on mining firms with substantial tangible assets and employees.

**Table 4. The effective corporate income tax is above 15%**

Taxable income group	Number of Taxpayers	Taxable income (Rand million)	Average tax rate
A: < -10 000 000	6,151	-877,241	-0.1%
B: -5 000 001 to -10 000 000	4,936	-34,523	0.0%
C: -1 000 001 to -5 000 000	26,106	-57,609	0.0%
D: -500 001 to -1 000 000	18,045	-12,932	-0.1%
E: -250 001 to -500 000	18,331	-6,641	0.0%
F: -100 001 to -250 000	20,698	-3,453	-0.1%
G: -1 to -100 000	40,533	-1,357	-2.7%
H: =0	109,322	-	0.0%
I: 1 to 100 000	40,867	1,621	17.4%
J: 100 001 to 250 000	19,992	3,303	19.7%
K: 250 001 to 500 000	16,825	6,062	20.2%
L: 500 001 to 750 000	9,084	5,556	23.3%
M: 750 001 to 1 000 000	5,596	4,868	25.7%
N: 1 000 001 to 2 500 000	12,510	19,868	27.6%
O: 2 500 001 to 5 000 000	6,214	21,789	28.8%
P: 5 000 001 to 7 500 000	2,654	16,233	28.3%
Q: 7 500 001 to 10 000 000	1,422	12,281	28.1%
R: 10 000 001 to 25 000 000	2,899	44,955	28.1%
S: 25 000 001 to 50 000 000	1,155	40,367	28.1%
T: 50 000 001 to 75 000 000	391	23,613	27.9%
U: 75 000 001 to 100 000 000	224	19,480	28.5%
V: 100 000 001 to 200 000 000	332	46,250	28.0%
W: >200 000 001	342	394,905	27.1%

Note: For the 2021 Tax Statistics publication, SARS has reclassified these previously effective rates as average tax rates.

Source: South African Revenue Service (2021), Tax Statistics.

South Africa will benefit from the Pillar Two as it should reduce tax competition from some regional jurisdictions. However, Pillar Two could limit the effectiveness of some generous tax incentives from the point of view of attracting investment. The level of tax benefits that the government can provide to foreign investors will be limited because other jurisdictions will be able to apply a top-up tax up to 15% to the low-taxed profits (OECD, 2020c). South Africa should review its tax incentives policy with respect to this new global taxation rule and ensure its compliance and its effectiveness in terms of reaching its objectives.

### **Reforming the taxation of SMEs**

Small business tax reductions amount to between ZAR 2.5 and ZAR 3 billion per year (Table 2). The reduction comes from two special tax regimes for small businesses. First, there is a simplified microbusiness (including self-employed) regime for microenterprises with a turnover below ZAR 1 million. It allows tax-free gross income of ZAR 335 000 and a marginal rate that rises to 3% of turnover. The take up rate of the microbusiness regime is low, in part because loss making firms are also required to pay tax on their turnover. Second, there is a “Small Business Corporations” regime designed for firms with turnover between ZAR 1 million and ZAR 20 million. Currently, small corporations are taxed at 0% on the first ZAR 87,300 of taxable income earned, 7% on the amount above ZAR 87,300 but not exceeding ZAR 365,000, 21% on the amount above ZAR 365,000 but not exceeding ZAR 550,000, and 28% on the amount exceeding ZAR 550,000.

The large jumps in tax rates for small businesses, when their taxable income grows above the thresholds, can create disincentives to grow and incentives to hide income or inflate costs. A disproportionate number of firms is declaring taxable income just below the three thresholds (Boonzaaier et al., 2016; Bell, 2020).

An alternative is to merge the two regimes and to introduce a progressive tax rate schedule that would lower the tax burden on businesses with lower turnover, such that they face an incentive to enter the formal economy, and higher presumptive tax rates for larger firms, such that they are induced to enter the standard tax regime. The presumptive tax rates could also vary across sectors, aligned with the average sector-specific profitability rates. The Davis Tax Committee (2014, 2016) has been critical of the Small Business Corporations, noting that it has become ineffective as it largely benefits service-related small businesses (such as financial, education, real estate, medical and veterinary services). In contrast, the system was intended to benefit emerging businesses or to assist ailing enterprises in an assessed loss position. The Small Business Corporations scheme could be restricted to young firms, so that after a fixed period, firms “graduate” to the standard regime (with measures to ensure firms do not abuse the system). Such a reform could be accompanied by a reform of the presumptive tax regime for very small businesses.

Other concerns with these regimes, and in general, are administrative costs for the South African Revenue Services (SARS), while their share of collected taxes is relatively low (around 4% of tax revenue and around 11% of VAT). In particular, slow processing of VAT refunds has been a source of burden. SARS has increased its assistance for SMEs with 138 small business desks at its branches and a call centre. SARS effort to reduce the delays of VAT refunding should be pursued and monitored (SARS, 2020b). Recent changes to issue tax clearance certificates electronically are welcome. SARS should continue to expand its education and assistance to build capability and encourage compliance.

### ***Revenues from natural resource extraction could be increased***

The mining industry accounted for around 8% of economic activity in recent years, but with variation over the economic cycle. Gold and diamonds are the traditional mining activity but platinum, iron ore, copper, coal, manganese and other mineral resources represent an increasing and by now substantial source of activity. In 2010, South Africa adopted a new taxation system for mineral resources.

The government opted in 2010 for a royalties-based system to ensure an upfront and more stable revenue stream, as many countries with mining industries do. The royalty regime adopted is relatively complex as tax rates vary with profitability and imply a determination of taxable income based on sales. There is a floor of 0.5% and rates are capped at 7% for unrefined products and 5% for refined products. Nonetheless, as a royalty, it captures part of the normal return as well as the resource rent, affecting investment incentives. The mining taxation regime has two factors to provide incentives for investing in the sector: (i) an upfront full depreciation on mining investment, which can be carried forward indefinitely, and (ii) specific incentives to encourage exploration and development in the oil and gas industry. However, these incentives are reduced by “ring-fencing” of projects, which prevents depreciation expenses of one project from being offset by profits elsewhere (in the oil and gas industry, 10% of profits can be transferred to another project). This protects the tax base but reduces the immediate benefit of the incentives.

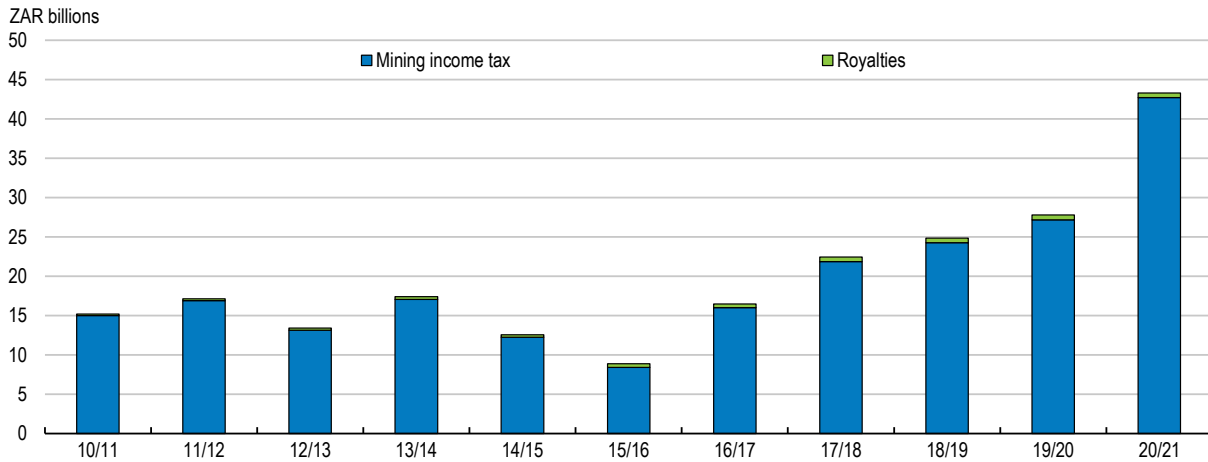
The royalty regime has generated increasing tax revenues (Figure 12). Mineral and Petroleum Resources Royalty (MPRR) revenues grew significantly by ZAR 2.4 billion (20.3%) to ZAR 14.2 billion in 2020/21, after an increase by 37.4% in 2019/20, due to a significant improvement in commodity prices such as iron ore as well as platinum (Figure 13). It is difficult to compare revenues from natural resources with other countries (OECD Economic Survey of South Africa, 2015a). The structure of ownership (state owned or private), the resources mix (since oil and gas extraction are often taxed more heavily) and the degree of diversification of the tax base make comparisons complicated (Table 5). However, comparing with royalty regimes in some countries, there is some scope to increase the effective tax rate in South Africa without overly dampening investment incentives. For example, the combination of corporate income tax and royalty regime could be kept while slightly increasing the marginal rate of the royalty regime.

The Davis tax committee recommended that the upfront capital expenditure deductions be abolished and to replace it with an accelerated deduction scheme as in the manufacturing industry. Aligning further the mining sector’s tax regime with the general taxation regime implies removing the capital depreciation allowance and the ring-fence scheme. The SARS estimated the amount of unredeemed capital



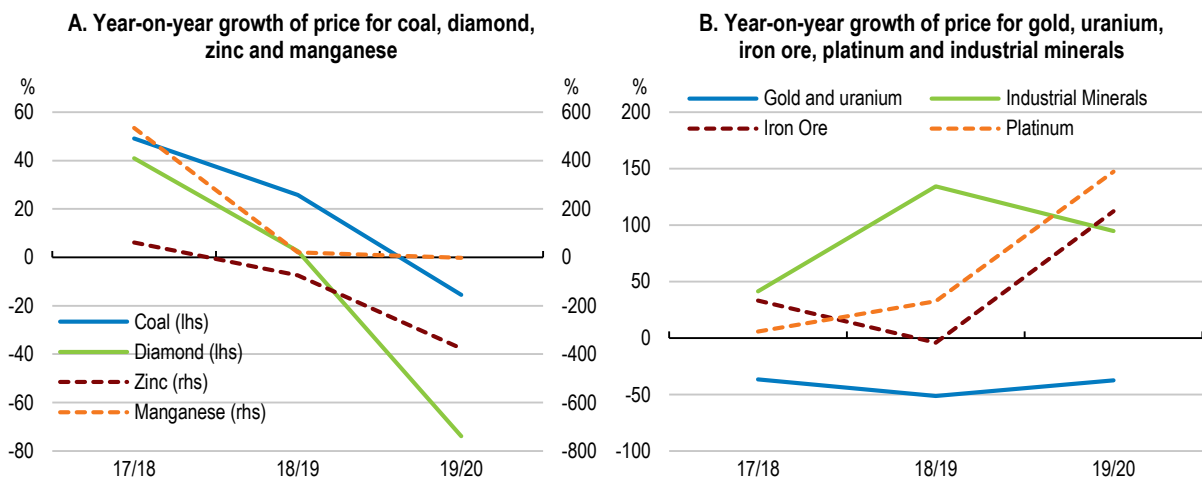
expenditure to be around ZAR 140 billion in 2015. An outright removal of these unredeemed capital expenditure would convert them into assessed losses and therefore an important foregone tax revenue. Mining investments are important, and it is relevant to provide incentives to attract investment. However, a 100% capital depreciation regime, including expenses unrelated to capital expenditures seems overly generous. The capital depreciation regime could be amended to reduce its generosity.

**Figure 12. Royalties added 2.5% to revenues from the mining sector**



Note: Mining and quarrying sector.  
Source: South African Revenue Service, Tax Statistics 2017 and 2021.

**Figure 13. Mineral and petroleum resources royalty revenues reflect price volatility**



Source: South African Revenue Service, Tax Statistics 2020.

**Table 5. There is room to increase the marginal rate of the royalty regime**

Country	Corporate tax rate	Royalty rate for key mineral resources	Tax base for royalty	Other mining taxes
Australia	30% for entities with turnover greater than AUD10 million.	2.5-20%, or AUD\$0.5-AUD\$2.64 per tonne, depending on mineral types and States/Territories <sup>[1]</sup>	Value or production volume	Petroleum resource rent tax at 40% on taxable upstream profits from a petroleum project.
Brazil	Base rate: 15% High income rate: 25% Social contribution on profits: 9%	State/municipality royalty: 0.2-3% Surface rights royalty: 0.1-1.5%	Net revenue	Inspection tax at up to US\$3 per tonne of ore. Social welfare tax at 0.65% (cumulative) and 1.65% (non-cumulative); service importation 1.65% and good importation 9.65%. Municipal service tax at maximum 5%.
Chile	4–20% for medium-scale operations; 24% for large operations	0–14% depending on production	Production volume	External trade tax of 6% for import of minerals.
Colombia	32%	1–12%, depending on mineral types	Production volume	Dividends tax: 10%. Industry and trade tax: 0.2-1.1%.
Peru	29.5%	1–12%	Operating profit	Dividends withholding tax: 5%. Special mining tax: 2–8.4%. Special mining contribution: 4–13.12%. Temporary tax on net assets: 0-0.4%. Financial transaction tax: 0.005%.
South Africa	28% for all minerals other than gold. Formula for gold mining tax	0.5-5% for refined minerals and 0.5-7% for unrefined minerals	Value of the minerals	Capital gain tax on disposal of assets at 20%. Withholding tax on dividends at 20%, and withholding tax on interest at 15%.

Note: 1) Royalty rates vary by States/Territories.

Source: Cunsolo and McKenzie (2020); Deloitte (2013); Advogados (2019); Muñoz (2019); Bambach and Pulgar (2020); Salazar, Serrano and Ochoa (2021); Pardo and Lugo (2020); Pickmann (2019); SARS (2021); FERDI (2021).

## Taxes on goods and services are large and effective

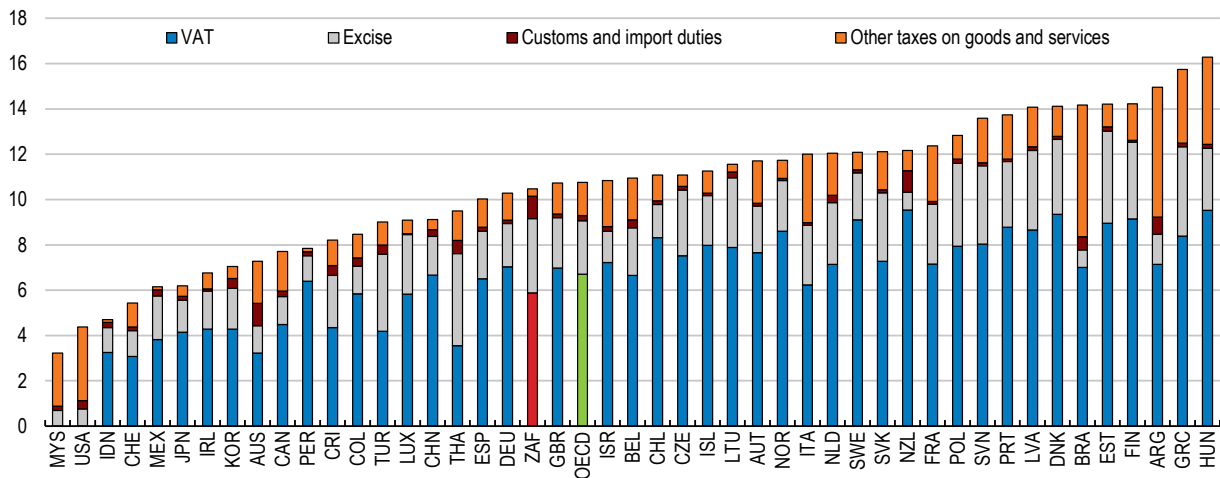
### *The VAT system performs relatively well*

The VAT is the second largest source of tax revenue, on average representing a quarter of government revenue over the past decade and raising revenues comparable to that of OECD countries (Figure 14). From 1993 to 2017, the standard VAT rate has remained at the comparatively low level of 14% and applied to the vast majority of goods and services. The VAT rate was increased to 15% in 2018. However, there is preferential treatment for a number of items and services, mostly in the form of a reduced VAT rate (of 0%). Zero-rated items and services include 19 basic food items, petrol and diesel (in addition to exports, which is a basic design feature of a VAT that is levied on a destination basis), while exempted items and services include public transport, education, financial services and childcare services. In 2014, the tax base was broadened to include imports of digital services.

The VAT revenue ratio calculated as the ratio of VAT revenue to consumption net of VAT as the potential base is an indicator of the VAT's performance in raising revenue. While the VAT revenue ratio compares favourably with OECD countries (Figure 15, Panel A), it declined in recent years, from 67% in 2015 to 60% in 2018 (Figure 15, Panel B). Although changes in consumption patterns in a low-growth environment where more zero-rated items are consumed may explain a decline in VAT performance, scope exists to strengthen the functioning of the VAT. Further detecting fraud and smuggling, and measures to increase VAT registration and reduce informality will increase revenues.

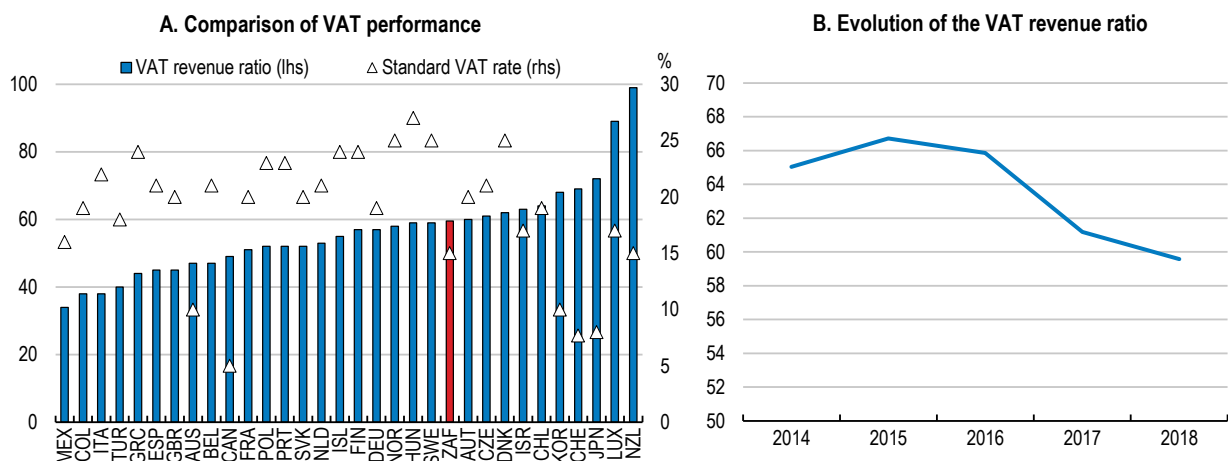
**Figure 14. VAT revenues are close to OECD countries**

Revenue from taxes on goods and services, % of GDP, 2019



Source: OECD Tax Statistics database.

**Figure 15. The collection of VAT remains performant**



Note: The VAT Revenue Ratio is calculated as actual VAT revenue divided by potential VAT revenue (the standard rate applied to total final consumption less VAT revenue). For Panel A, data are for 2018 for OECD countries and 2017/18 for South Africa.

Source: OECD Consumption Tax Trends 2020, Table 2.7. VAT Revenue Ratio (VRR) 2018; OECD National Account Database; Tax Statistics; OECD Calculations.

Many OECD countries have used technology to enhance the reporting of tax relevant data to tax authorities. Thirty-one OECD countries have generalised mandatory e-filing of VAT returns (OECD, 2015b), and have introduced or are considering the introduction of an obligation for taxpayers to provide transaction data electronically to tax authorities, sometimes in real time. These measures generally require that detailed information be provided in an electronic format at the level of each individual taxable transaction. This information can include invoicing information and accounting data or any other information that allows tax authorities to monitor supplies made and/or received by individual taxpayers (OECD, 2020d). As the SARS has stepped up e-filing, using third-party data and cross checking could improve the detection of underreporting and undue claims of VAT refund. Introducing electronic invoices would improve VAT collections and increase information available to detect fraudulent behaviours (see Box 1). South Africa could start with mandatory electronic VAT invoicing for business-to-business and business to government transactions.

### Box 1. Features of electronic invoicing in selected OECD countries

**Chile:** The obligation to use electronic invoicing and to provide B2B transaction information electronically to tax authorities started in 2003. In 2017, this obligation was extended to the provision of other accounting data to an electronic record kept by the tax authority. Transaction data must be transmitted to tax authorities in real time. As from January 2021, the Law 21210 has introduced the obligation to issue B2C invoices electronically. The electronic invoice can be sent through any electronic method (cell phone, email, etc.) provided that it is accessible to the consumer and the business.

**France:** Electronic invoicing is not mandatory, except for B2G supplies. Electronic invoicing should become mandatory for all B2B supplies by 2025 at the latest. Electronic transaction information: taxpayers keeping electronic accounts must provide them in the form of digital files upon request by tax administration for control purposes.

**Hungary:** Invoicing information must be transmitted to the tax authorities at the same time the invoice is emitted by the taxpayer (real time reporting). Information on ‘paper invoices’ must be provided to the tax authorities within a 1 or 5-day deadline (depending on whether the value of VAT figuring in the invoice surpasses – respectively – HUF 500 000 or HUF 100 000). Information must be provided concerning all invoices emitted in respect of domestic supplies to taxable persons registered in Hungary (B2B).

**Italy:** All VAT-registered businesses established in Italy are obliged to accept and issue invoices in electronic format through the Italian Revenue Agency’s e-invoicing platform, Sistema di Interscambio (SdI), except for VAT exempted transactions. From 1 January 2020 and with a few exceptions, taxpayers engaged in the retail trade and similar activities must register their supplies electronically and transmit them to the Italian Revenue Agency, regardless of their turnover.

**Mexico:** Electronic invoicing is mandatory since 1 January 2014. The transmission of transaction data to the tax authority is mandatory since 1 January 2015. This obligation applies to all taxpayers and covers the domestic supplies of goods and services for both B2B and B2C transactions. Periodic transmission of transaction information is also imposed to all taxpayers.

**Turkey:** From 1 January 2020 paper invoices are no longer legally valid. All invoices must be sent under electronic format via the “e-arşiv fatura” system. Every time an electronic invoice is issued, the recipient receives a notification by email. All businesses must file a daily statement with a summary list with all the e-arşiv fatura and send it to the tax administration.

Source: OECD (2020), Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues, OECD Publishing, Paris, <https://doi.org/10.1787/152def2d-en>.

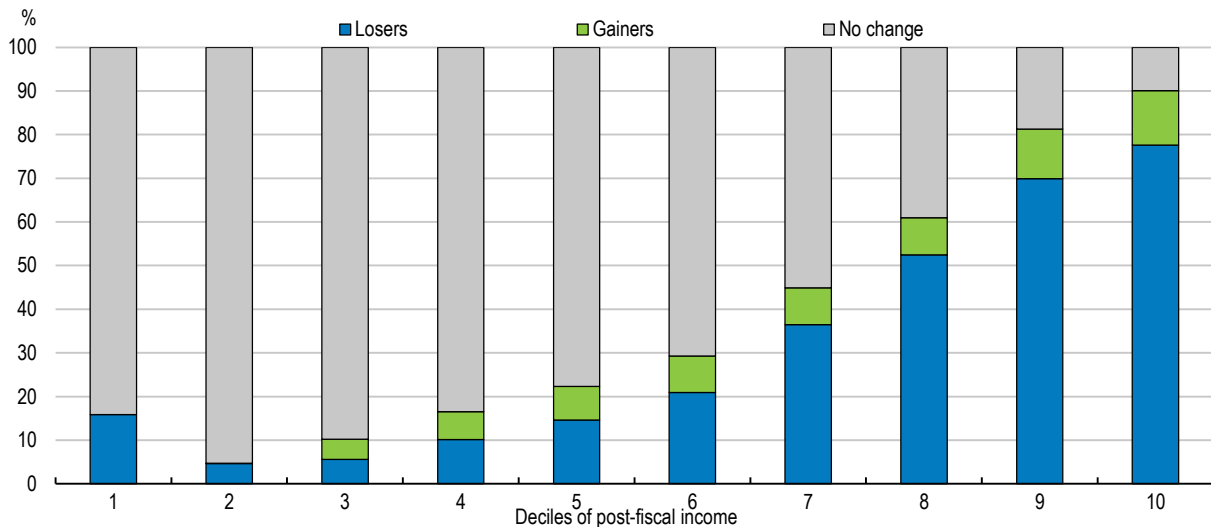
Given that consumption taxes are one of the least distortive forms of taxation and that the current VAT rate is relatively low, there is scope to raise additional revenues to help improve fiscal sustainability. Lifting the rate by 1 percentage point could raise VAT revenues by 7%, equivalent to ZAR 17 billion (using the current rate of VAT efficiency to allow for leakage). The VAT rate hike in 2018 from 14% to 15% raised concerns about its impact on poverty and inequality. An alternative proposal consisted of a reduction in the number of zero-rated items and an increase in direct social transfers to counter the effects of raising VAT rates on poorer households.

Different analyses show that the VAT is mildly progressive, with the implicit VAT rate (VAT paid as a share of disposable income) rising from 9.5% for the lowest income decile to 12% for the highest income decile (Inchauste et al., 2015). This is largely because food items with preferential VAT treatment are a larger share of overall consumption for poorer households (Jansen and Calitz 2015). A recent assessment of a potential VAT rate increase shows that high-income deciles would be more affected than low-income deciles. The simulation by Gcabo et al. (2019) indicates that the lowest decile is, however, affected even after the increase in social grants (Figure 16). Nonetheless, as many adults and youth do not benefit from

social transfers, it is preferable for political acceptability to maintain the preferential VAT regime, except with respect to diesel and petrol given their negative impact on climate, and to better target transfers to low-income households (i.e. increasing the amount of the transfer and ensuring that all poor households are reached) when increasing the standard VAT rate.

**Figure 16. The impact of the VAT rate increase varies across income decile**

Percentage of losers, gainers and those neither losing nor gaining by post-fiscal income deciles, 2018



Source: Gcabo et al. (2019), Modelling value-added tax (VAT) in South Africa: Assessing the distributional impact of the recent increase in the VAT rate and options for redress through the benefits system, WIDER Working Paper 2019/13.

### **Other indirect taxes contribute significantly to government revenues**

#### *Excise taxes raise significant revenues*

Excise taxes on fuel, alcohol and tobacco are equivalent to 10% of government revenues. Fuel excises are discussed below in relation to environmentally related taxes. Excise taxes on alcohol and tobacco are set to reduce consumption of those products, improving the health of citizens. Tobacco consumption remains high, as 19% of the adult population are daily smokers. Smoking is particularly prevalent among men with 31% of them smoking daily (OECD South Africa Economic Survey, 2020a). Since 1994, the government has raised the excise tax on tobacco significantly. The combined excise tax and the value added tax was increased from 32% of the retail price in 1996 to 52% in 2006. However, the tax burden of 52% (i.e. excise tax plus VAT) of the retail selling price of the most popular brands was changed in 2015 when government decided to no longer levy VAT but only excise duties on tobacco. This reform effectively reduced the overall tax burden to 40%. Since 2017, the tax on tobacco has been increased further every year.

The World Health Organisation recommends that the excise tax on tobacco be at least 70% of the final retail price, given the evidence that taxation is the most cost-effective method of reducing consumption (WHO, 2011). Fuchs et al. (2019) estimate the years of life lost because of premature deaths attributable to smoking is around 100 years for the whole working-age population in South Africa. Stacey et al. (2018) argue that increasing health tax excises significantly in South Africa will lead to improvements in health and raise revenue. Health tax revenues could be earmarked to roll out universal health care across the entire population. Efforts to reduce tobacco consumption should be pursued both by further increasing excise taxes while developing specific information and education campaigns.

The government increased the excise duties on alcohol and tobacco by 8% for 2021/2022. To tax these products more appropriately, excise duties are differentiated by product type. Products comparable to cigarettes that are normally sold in packs of 10 or 20 sticks are taxed accordingly, while other products will

be taxed by weight. The increase of the excise duty on tobacco puts its incidence on final retail price to 45% on average.

However, price differentials with neighbouring countries are already inducing smuggling (SARS, 2014; OECD South Africa Economic Survey, 2015a). Estimations conclude that illicit cigarettes represent between 23% and 35% of the market (Van der Zee et al., 2020 and Vellios et al., 2019). The weakening of the South African Revenue Service may have contributed to the development of illicit cigarettes traffic (see section below). Developing border controls, including random controls from SACU countries and traceability of local productions would limit illicit cigarettes trafficking and increase revenues.

Alcohol consumption is also high. About one third of those aged above 15 years report drinking alcohol regularly and 15.9% and 2.7% of men and women, respectively, are alcohol dependent (Health System Trust, 2018). In 2015, it was decided to no longer tax alcohol under the VAT but to levy only excise duties; this reform reduced the tax burden on alcohol to 11%, 23% and 36% from 23%, 35% and 48% for wine, beer and spirits, respectively. In almost all the following years, the excise taxes on alcoholic beverages were raised with a different treatment for local beer with low alcohol content and wine.

Policy measures targeted at reducing alcohol consumption should follow an integrated approach that extends beyond price incentives, including educational and preventive programmes. Additional measures to reduce alcohol consumption could therefore include the banning of advertisement, restricting places of sale as well as strengthening preventive programmes targeted at vulnerable population groups, which tend to consume more alcohol (National Treasury, 2014 and OECD South Africa Economic Survey, 2020a).

South Africa has one of the highest levels of obesity among its population when compared to OECD and emerging countries. 37.3% of adult women are obese (OECD health Statistics). The Health Promotion Levy was implemented on 1 April 2018. It is a levy imposed on sugary beverages to decrease diabetes, obesity and other related diseases in South Africa. The rate was fixed at 2.1 cents per gram in 2018 and increased to 2.21 cents per gram in 2019 with the first 4 grams per 100 ml free of levy. Following the introduction of the health levy, urban households' consumption of sugary beverages fell by 29% and the highest drop in consumption was found amongst low-income households (Hofman et al., 2021). The sale of sweetened beverages in school should be banned and preventive health messages linked to their advertisement.

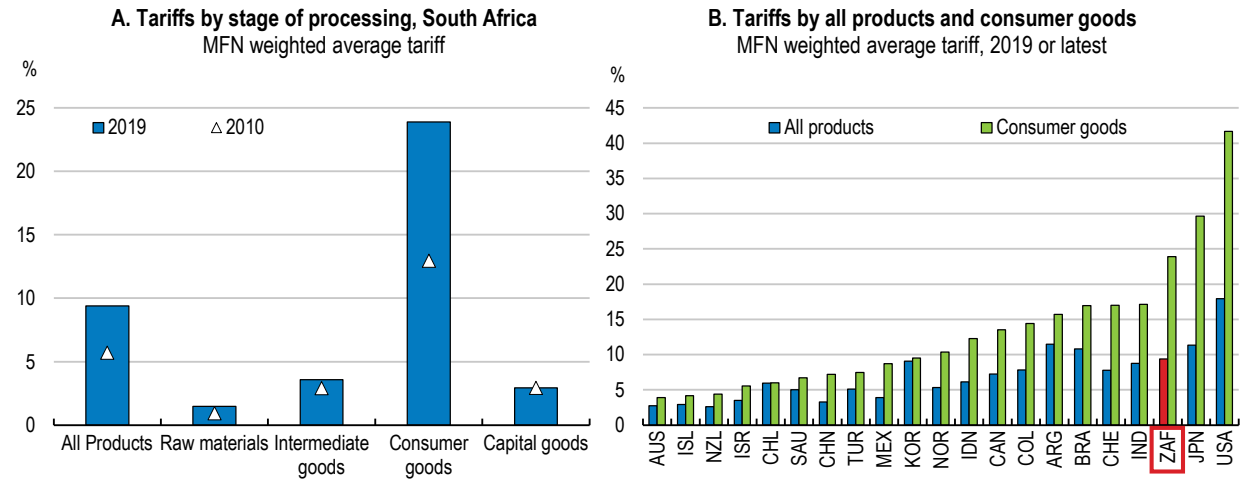
#### *Trade taxes remain significant*

South Africa receives a small but significant share of its tax revenue from taxes on trade, as do many emerging economies, equivalent to around 4% of government revenues. This mostly comprises customs duties on imports, with a common external tariff applying to imports from outside the Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa and Swaziland) and a preferential rate for economies with bilateral trade agreements. Revenue from import duties is pooled and redistributed among the customs union members; South Africa acts as a gatekeeper for the Custom Union and retains around 40% of revenue raised and effectively sets tariff levels as a Tariff Board for the Custom Union has not yet been established.

South Africa has largely liberalised its tariffs in the early 2000s. Empirical evidence suggests that earlier trade liberalisation boosted growth and productivity, including through greater domestic market competition (Fall and Laëngle, 2020; Edwards and Rankin, 2015). However, in the past decade, the process of tariff reduction has largely stalled, with rates remaining particularly high on consumer goods (Figure 17). These tariffs reflect industrial policy choices to encourage local manufacturing. Tariffs on clothing and footwear (the highest) average almost 40% and particularly affect poorer households, for whom these items represent a larger share of total consumption. Tariffs are also high for motor vehicles and parts as part of the automotive industry programme (under the automotive industry programme local manufacturers can also receive a refund of tariffs paid). In addition, VAT is applied on top of custom tariffs on most imported consumer goods. Better balancing the tariff structure between protection of local industry and sufficient

competition could improve consumers' well-being, in particular poor households. In the long run, competition is also good for industry as it forces firms to become more competitive.

**Figure 17. Tariffs on consumer goods remain high**



Source: UNCTAD Trade Analysis Information System (TRAINS); World Integrated Trade Solution.

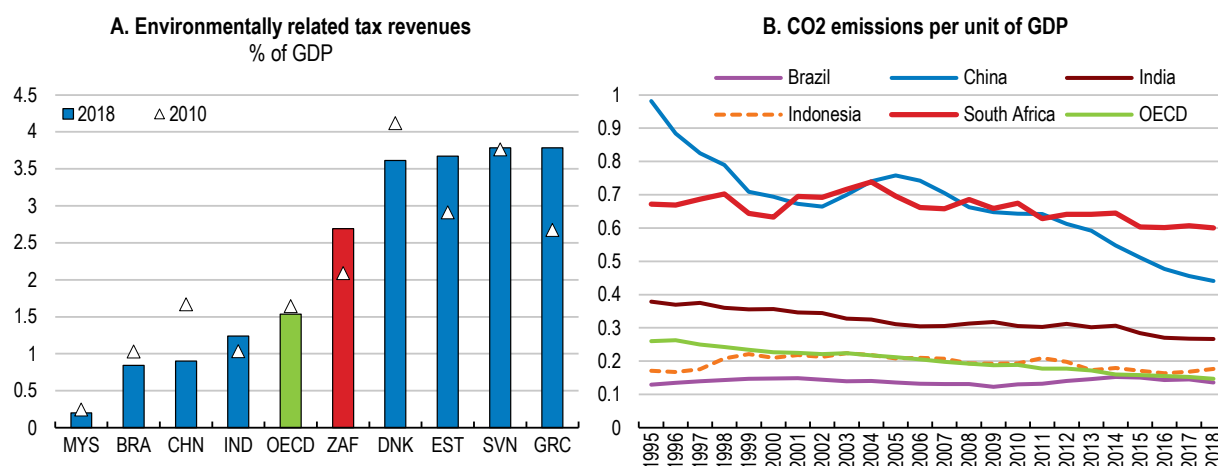
### Strengthening the tax system to cope with new challenges

#### Environmental tax policy

South Africa is increasingly strengthening its environmental tax policy to curb its greenhouse gas emissions. The overall revenue from environmentally related taxes has risen from 2.1% of GDP in 2010 to 2.7% in 2017. This is above the (unweighted) average of OECD countries and higher than in most emerging countries (Figure 18, Panel A). Since 2000, several taxes on waste and pollutants have been introduced, with levies on international air travel, plastic bags, incandescent light bulbs, tyres and electricity from non-renewable sources.

The CO<sub>2</sub> per GDP emission intensity is high and has fallen little since 2000 (Figure 18, Panel B), in part reflecting the high-energy intensity of the economy. This largely stems from the economy's reliance on coal, which accounts for around 70% of total energy and 85% of electricity generated. Coal is the main energy source in industrial processes. In its 2018 draft Integrated Resource Plan (IRP), South Africa announced steps to reduce CO<sub>2</sub> emissions in electricity generation. It announced decommissioning of 35 out of currently 42 Gigawatts (GW) of coal-fired capacity by 2050 and to expand renewable electricity generation. However, close to 6 GW of new coal-fired plants are under construction. New plants expose South Africa to the risk of having to write them off early to meet its CO<sub>2</sub> emission targets.



**Figure 18. Environmentally related tax revenues are increasing but emissions remain high**

Note: Panel A: Data for South Africa are for 2017.

Source: OECD Green growth Indicators.

To reduce its greenhouse gas emissions, South Africa introduced a carbon tax in 2019 at a tax rate of ZAR 120 (EUR 6.5) per tonne of carbon dioxide equivalent emissions. The gradual implementation of the tax provides for a first phase from 1 June 2019 to 31 December 2022 and a second phase from 2023 to 2030. The carbon tax rate will increase annually by inflation plus 2 per cent until 2022 and annually by inflation thereafter. However, in 2021/22, businesses were granted a delay for the payment of the carbon tax as part of the COVID-19 pandemic response measures. Also, significant industry-specific tax-free emissions allowances, ranging from 60% to 95% of emissions, lead in a mild average carbon tax rate ranging from ZAR 6 to ZAR 48 (EUR 0.3 to EUR 2.7) per tonne of carbon dioxide equivalent emissions (OECD, 2021b). Therefore, South Africa's carbon price is low by international standards (Table 5).

The distribution of exemptions across industries places the burden of adjustment disproportionately on low emission sectors and creates unequal price signals, thereby raising the cost of abatement and reducing the share of emissions effectively priced (Table 5). An effective and efficient carbon tax requires a uniform marginal rate applied to all sources of emissions (OECD, 2011). This would reduce the economy's dependence on energy- and carbon-intensive production while making production more labour intensive (Alton et al., 2014). Carbon tax exemptions should be progressively phased out, along with the increase in the share of renewable energy in electricity generation.

In addition, as provided by the 2019 Carbon Act, the National Treasury published amendments to the regulations of the carbon-offset schemes in July 2021 (National Treasury, 2021b). They specify the eligibility criteria for carbon offset projects, procedures for claiming carbon offset allowance and administration of the carbon offset mechanism. The carbon offset tax allowance enables firms to reduce their emissions and carbon tax liability by up to 10% of their total greenhouse gas emissions by investing in carbon mitigation projects. Firms have to register officially their mitigation projects in the Verra registry (an international certificate of voluntary cancellation) or in national registries under the Clean Development Mechanism for claiming carbon offset credits.

To guarantee the integrity of the carbon offsetting mechanism, the Department of Mineral Resources and Energy should finalise quickly the regulations defining local standards that determine whether a project qualifies as a carbon offset project. Also, strict monitoring of the certification process of projects will be key in safeguarding the integrity of the carbon offsetting mechanism.

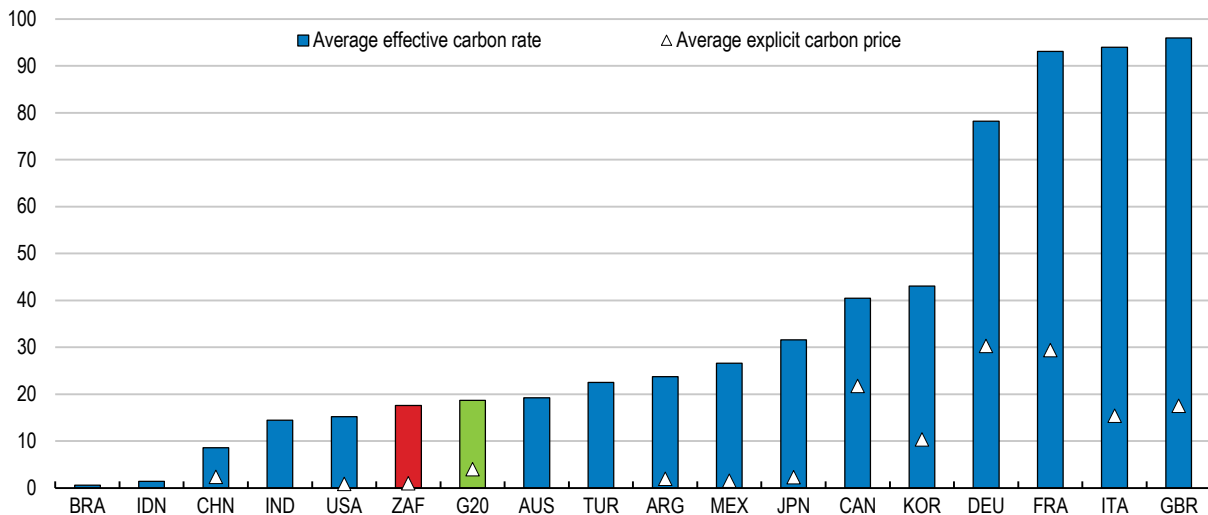
Finally, the carbon component of other energy taxes, such as the environmental levy on electricity generated from fossil fuels and nuclear, should be reviewed to simplify the policy framework and ensure



that the effective rate is increasing over time. A review of the impact of the carbon tax three years after implementation is planned by 2022.

**Figure 19. The carbon price is low in part due to exemptions**

EUR per tonne of CO<sub>2</sub>, 2021

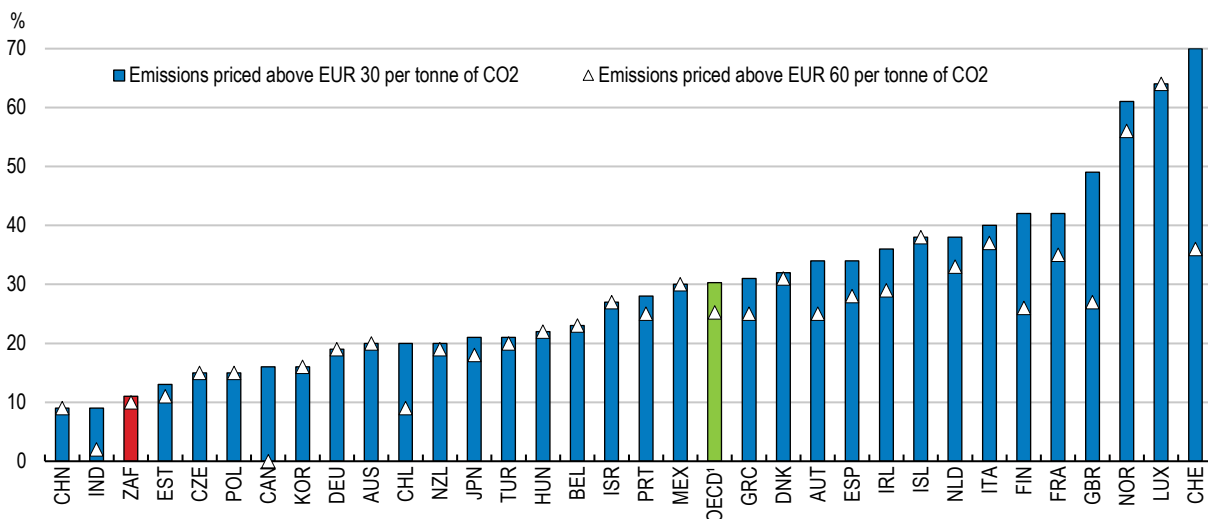


Note: G20 includes all G20 countries, except Saudi Arabia. Taxes are those applicable on 1 April 2021. Average effective carbon rate is the sum of explicit carbon prices and fuel excise taxes. Explicit carbon price refers to price that uses carbon taxes and emissions trading systems to raise the cost of carbon-intensive fuels, thus encouraging firms and households to make more climate-friendly choices. Emissions refer to energy-related CO<sub>2</sub> only and are calculated based on energy use data for 2018 from IEA, World Energy Statistics and Balances 2020. Carbon prices are averaged across all energy-related emissions from G20 countries, including those that are not covered by any carbon pricing instrument. All rates are expressed in real 2021 EUR using the latest available OECD exchange rate and inflation data; change can thus be affected by inflation and exchange-rate fluctuations. Prices are rounded to the nearest euro cent.

Source: OECD (2021), Carbon pricing in times of COVID-19: What has changed in G20 economies? OECD, Paris.

**Figure 20. The share of emissions taxed remains low**

Emissions priced in percentage of total emissions, 2018



1. Average of OECD countries with available data.

Source: OECD (2021). Effective Carbon Rates 2021, <http://oe.cd/ECR2021>.

Fuel taxes are relatively high and contribute significantly to government revenues (Table 6). Taxes on transport fuels represent around 40% of the fuel price (in February 2021). This is around the OECD

average and similar to large non-OECD countries. Nonetheless, there is scope for further gradual increases. IMF estimates on the level of taxation needed to correct for externalities revealed that fuel taxes should be increased further to reflect the cost of road accidents, which are high in South Africa, and congestion, though congestion charging would be more efficient. Financing and regulation of road infrastructure should be reformed, including by replacing the ineffective e-toll system by a pre-payment e-toll system. Moreover, some industries are currently eligible for a full or partial refund of the fuel levy for diesel use, notably electricity, mining and agriculture, and individuals benefit from under-taxed fringe benefits for the private use of company cars within the personal income tax. These tax benefits for individuals and businesses should be phased out or reduced and public transport developed to reduce the greenhouse footprint.

**Table 6. Taxes on fuel are high**

Rands/litre	2020/21		2021/22	
	93 octane petrol	Diesel	93 octane petrol	Diesel
General fuel levy	3.70	3.55	3.70	3.55
Road Accident Fund levy	2.07	2.07	2.07	2.07
Customs and excise levy	0.04	0.04	0.04	0.04
Carbon tax <sup>1</sup>	0.07	0.08	0.07	0.08
Total	5.88	5.74	5.88	5.74
Pump price <sup>2</sup>	14.44	12.75	14.44	12.75
Taxes as a percentage of pump price	40.7%	45.0%	40.7%	45.0%
<b>Fuel levy</b>				
		2020/21		2021/22
Rand million		75 502		89 883
% of Total revenue		6.1%		5.8%

Note: 1) The carbon tax on fuel became effective from 5 June 2019. 2) Average Gauteng pump price for the 2019/20 and 2020/21 years.

Source: National Treasury, Budget Review, February 2021.

### ***Improving digital economy taxation to avoid revenue leakage***

South Africa pioneered the taxation of cross-border e-commerce transactions (referred to as “electronic services”) in 2014. Foreign suppliers have to register and hold a VAT account on these transactions if their turnover of supplies to South African residents exceeds ZAR 50 000. The turnover threshold has been increased to ZAR 1 million in 2019 to align it with the local transaction threshold. However, because electronic services were narrowly defined, few business-to-business transactions were effectively captured. Following the release of the OECD VAT/GST Guidelines, South Africa, like most other VAT jurisdictions, has broadened in 2019 the scope of e-commerce subject to VAT to cover all services electronically provided, including business-to-business transactions (National Treasury, 2019).

Efforts to enhance compliance and enforcement of the cross-border tax rules should continue. In particular, adopting the 2020 OECD Model for Reporting Rules by platform operators would facilitate exchange of information with other jurisdictions implementing the model (OECD, 2020e). The SARS is strengthening the monitoring and engagement with non-resident platforms to improve compliance. However, the ZAR 1 million turnover threshold appears high and, in addition to the VAT exemptions for online sales with a value below ZAR 500, could limit the scope for compliance. The turnover threshold for electronic services VAT compliance should be reviewed in line with international standards (Box 2).

### Box 2. Examples of e-commerce VAT exemption and threshold policies

**Australia:** From 1 July 2018, foreign suppliers, including digital platforms, shipping low-value goods (i.e. with a value of AUD 1 000 or less) to consumers in Australia are required to register, collect and remit the good and service taxes on those supplies if the volume of such supplies exceeds the Good and Service Tax registration threshold of AUD 75 000 per annum.

**Canada:** From July 1, 2020, the threshold is CAD 40 for goods that are imported by courier from Mexico or the United States. The threshold is CAD 20 for all other couriers and postal importations.

**New Zealand:** From 1 December 2019, the shipping values is of NZD 1 000 or less and the registration threshold is of NZD 60 000 per annum. Digital platforms including foreign suppliers are liable to collect the GST on such supplies made through them.

**Norway:** From 1 April 2020, the shipping value is below NOK 3 000 and the registration threshold is of NOK 50 000 per annum. Digital platforms, including foreign suppliers, are liable for collecting the VAT on such supplies made through them.

**United Kingdom:** There is no low value consignments relief on imports of goods into the UK from the Channel Islands purchased as part of a mail order/distance sale transaction. As a result of the UK's departure from the European Union, changes will be introduced from the end of December 2020 to remove low value consignment relief on imports of goods. Foreign suppliers and online marketplaces making supplies of goods not exceeding GBP135 in value imported and delivered to UK customers will be required to register, collect and remit the VAT.

**European Union:** From July 2021, the VAT exemption threshold for the importation of low-value goods will be removed. Foreign suppliers or digital platforms (marketplaces) selling low-value goods (i.e. goods with value below EUR 150) that are imported and delivered to consumers in the EU will be required to register, collect and remit VAT on those supplies. There will be no registration threshold and foreign suppliers will have to register and account for VAT from the first supply. Foreign suppliers/online marketplaces will be able to register under a simplified "pay only" registration scheme (One-Stop-Shop – OSS) in the Member State of their choice.

Source: OECD (2020), Consumption Tax Trends 2020: VAT/GST and Excise Rates, Trends and Policy Issues, OECD Publishing, Paris, <https://doi.org/10.1787/152def2d-en>.

### ***Strengthening international tax co-operation to fight tax evasion***

International tax avoidance and profit-shifting by multinational companies are a source of revenue loss for the government. These activities can also affect growth by distorting competition and inducing an inefficient allocation of resources, and also weaken other taxpayers' compliance. Over the last decade, the OECD along with many advanced and developing economies and regional tax bodies, worked to develop new rules and processes to strengthen the functioning of the international tax system. International efforts to address weaknesses in the international tax system rely on two building blocks: (i) promoting transparency and exchange of information among jurisdictions for tax purposes through the work of the Global Forum on Tax Transparency and Exchange of Information and (ii) tackling tax avoidance with the OECD/G20's Base Erosion and Profit Shifting (BEPS) project.

South Africa is largely compliant with the international framework and has been an active member of the international tax fora (Table 7). The first round of the review of the Exchange of Information on Request (EOIR) framework concluded that South Africa's framework needs improvement on the availability of information on ownership and identity, and accounting and banking information (OECD, 2021c). In particular, it was recommended to South Africa to ensure that the beneficial owners of all types of partnerships and trusts are always identified. The review also recommended that the government should proceed with the adjustment of the anti-money laundering legislation to close the loophole on entity owners.

Also, the company registry should be strengthened to guarantee that accurate and up-to-date beneficial ownership information on all relevant entities are in line with international standards. South Africa could strengthen the use of EOIR framework to collect more information on capital income earned and held abroad.

South Africa's legal framework implementing the Standard for Automatic Exchange of Financial Account Information in Tax Matters (AEOI Standard) is in place and is consistent with the requirements of the AEOI Terms of Reference. This includes South Africa's domestic legislative framework requiring Reporting Financial Institutions to conduct the due diligence and reporting procedures (CR1) and its international legal framework to exchange the information with all of South Africa's Interested Appropriate Partners (CR2) (OECD, 2021d).

**Table 7. South Africa's adherence to international tax co-operation is good**

Exchange of information on request (EOIR)	
Global Forum membership	yes
EOIR rating round 1	compliant
EOIR rating round 2	Ongoing
Mutual Administrative Assistance Convention	in force
Automatic exchange of information (AEOI)	
Commitment to AEOI (CRS)	2017
CRS MCAA signed	yes
Legal frameworks' assessment	in place but needs improvement
Mutual Administrative Assistance Convention	in force
BEPS	
Inclusive Framework on BEPS membership	yes
Existence of harmful tax regimes (BEPS Action 5)	not harmful (no harmful regime exists)
Exchange of information on tax rulings (Action 5)	reviewed/no recommendations
Preventing treaty abuse (Action 6)	2021 review ongoing
CbC?–?Domestic law (Action 13)	legal framework in place
CbC?–?Information exchange network (Action 13)	activated
Effective dispute resolution (Action 14)	stage 2 reviewed & recommendations made
Multilateral Instrument (Action 15)	signed

Source: OECD, International tax co-operation: Key indicators and outcomes database.

South Africa has also swiftly implemented many of the recommendations of the OECD/G20 Base Erosion and Profit Shifting (BEPS) project (Table 7). South Africa has signed the Multilateral Instrument (Action 15) and should proceed swiftly with its ratification, which would close most of the remaining gaps in its effective dispute resolution framework (Action 14). Indeed, South Africa has an extensive tax treaty network with close to 80 tax treaties. Its treaties are mostly consistent with the requirements of the Action 14 Minimum Standard (OECD, 2021e), except for the fact that:

- Approximately 25% of its tax treaties neither contain a provision stating that mutual agreements shall be implemented notwithstanding any time limits in domestic law (which is required under Article 25 (2), second sentence of the OECD Model Tax Convention), nor the alternative provisions for Article 9 (1) and Article 7 (2) to set a time limit for making transfer pricing adjustments (OECD, 2021e).
- Approximately 10% of its tax treaties do not contain the equivalent of Article 25 (3), second sentence of the OECD Model Tax Convention stating that the competent authorities may consult together for the elimination of double taxation for cases not provided for in the tax treaty (OECD, 2021e).

Through the Multilateral Instrument, a number of South Africa's tax treaties will be modified to fulfil the requirements under the Action 14 Minimum Standard. Where treaties will not be modified, South Africa will need to update these tax rules to be compliant with the requirements under the Action 14 Minimum Standard via bilateral negotiations (OECD, 2021e). Moreover, the review of the Mutual Agreement Procedure (MAP) revealed that on average MAP cases were not closed within a timeframe of 24 months. This particularly concerns attribution/allocation of cases, as the average time needed for such cases is 35 months while for other cases the average is within the pursued 24-month average. Accordingly, South Africa should devote additional resources to the SARS to handle pending and future MAP cases in a timely, efficient and effective manner (OECD, 2021e).

## Improving the taxation of wealth to reduce inequalities

### *Wealth inequalities are high*

South Africa has the highest measured level of inequality in the world, which undermines social stability and inclusive growth. Wealth inequality is even higher than income inequality with a Gini coefficient of 0.9 compared to 0.67 for income inequality (Orthofer, 2016; Mbewe and Woolard, 2016). Recent analysis by Chatterjee et al. (2020), combining micro data and national accounts, shows the extent of wealth inequalities, with the top 10 per cent holding 85.6% of net wealth and the top 1 per cent 55% of net wealth (Table 8). Wealth inequality is a legacy of the apartheid and colonial system and since the move to democracy in 1994, it has not changed much. Mbewe and Woolard (2016) found that the average wealth of a black household is less than 5% of that of white households. Moreover, wealth inequalities are high among black households revealing the persistence of an unequal economic system. The level of wealth inequality has led to a debate whether a net wealth (net of debt) tax should be introduced (Davis Tax Committee, 2018).

South Africa does not have a net wealth tax levied on the value of assets and paid by the owner of the assets, but it has wealth transfer taxes for different types of assets (Table 9). Since a net wealth tax poses various technical problems regarding its valuation, capital income taxes and well-designed inheritance taxes or estate duties are usually considered more efficient and equitable than a net wealth tax (OECD, 2018a). As the Davis Tax Committee (2018) and the OECD (2018a) have argued, improving existing wealth transfer taxes along with appropriate taxation of the different income sources can reach the objective, over time, to limit intergenerational transmission of wealth inequalities.

**Table 8. Personal wealth is distributed very unequally (2017 data)**

	Number of adults	Wealth threshold	Average (2018 rand)	Average (2018 PPP \$)	Wealth share (%)
Full population	35 400 000		326 000	52 200	100
Bottom 90% (p0p90)	31 860 000		94 100	15 100	14.4
Bottom 50% (p0p50)	17 700 000		-16 000	-2 600	-2.5
Middle 40% (p50p90)	14 160 000	27 700	138 000	22 000	16.9
Top 10% (p90p100)	3 540 000	496 000	2 790 000	447 000	85.6
Top 1% (p99p100)	354 000	3 820 000	17 830 000	2 860 000	54.7
Top 0.1% (p99.9p100)	35 400	30 350 000	96 970 000	15 540 000	29.8
Top 0.01% (p99.99p100)	3 540	146 890 000	486 200 000	77 920 000	14.9

Note: The unit of observation is the individual adult aged 20 or above. Wealth thresholds are in 2018 rand.

Source: Chatterjee, A., L. Czajka and A. Gethin (2020), "Estimating the distribution of household wealth in South Africa", SA-TIED Working Paper 106, UNU-WIDER.

**Table 9. Main wealth and property taxes in South Africa**

Wealth tax	Description
Donations tax	It is levied at a rate of 20% on the value of a donation. With effect from 1 March 2018 the rate was increased to 25% of the value of cumulative donations exceeding ZAR 30 million. An annual exemption of ZAR 100 000 is available to natural persons.
<i>Estate Duty</i>	It is levied at a rate of the dutiable amount of a deceased estate. Estate duty is levied on property of residents and South African property of non-residents less allowable deductions. With effect from 1 March 2018 the duty is levied on the dutiable value of an estate at a rate of 20% on the first ZAR 30 million and at a rate of 25% above ZAR 30 million.
<i>Securities transfer tax (STT)</i>	It is levied at a rate of 0.25% on every transfer of a security.
<i>Transfer Duty</i>	It is levied on the acquisition of property as defined; at a progressive rate for all persons including companies, close corporations and trusts. As of 1 March 2016, a marginal rate of 13% applies to the portion of the value of property exceeding ZAR 10 million.

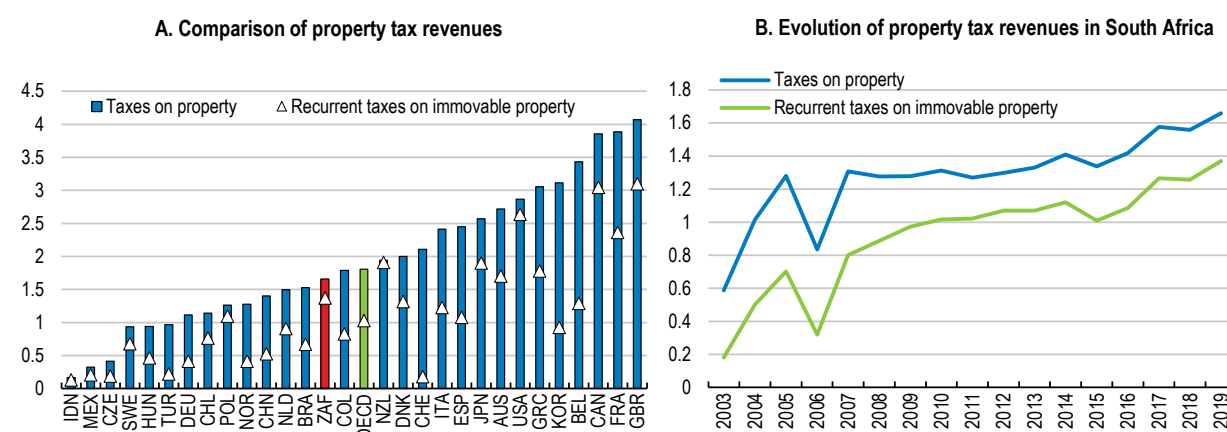
Source: South African Revenue Service (2020), Tax Statistics.

### Improving tax collection on wealth

The collection of existing wealth taxes could be improved. The collection of property revenues is modest, and the management could be improved. Property tax revenues, at 1.7% of GDP in 2018, are close to the OECD average (Figure 21, Panel A). The municipalities receive around 1.4% of GDP of the property tax, amounting to 18% of their revenues. Other taxes on property are levied by the central government and include transfer duties on the sale of real estate (which is less significant than in the average OECD country), a securities transaction tax and estate duty. Recurrent taxation on immovable property is the main component of property taxation (Figure 21, Panel B).

Greater reliance on property taxation is currently hampered by the great variation in the capacity of local governments in terms of revenue collection, financial operations and service delivery. The Auditor General regularly points to shortcomings in financial management in municipalities and half of all municipalities received unqualified audit reports in the last years (indicating that financial statements were presented fairly), with problems more common in poorer and more rural provinces (Auditor general, 2021). Improving the technical capacity of municipalities is key for a better performance in setting and collecting the property rates but also for improving the quality of services delivery. The government should step up the assistance to rural municipalities to increase their capacities. In some areas, mutualisation of administrative capacities between municipalities could improve the capacity to contract and deliver services.

**Figure 21. Property tax revenues are close to the OECD average and driven by recurrent taxation**  
% of GDP



Note: Data for 2019 in panel A.

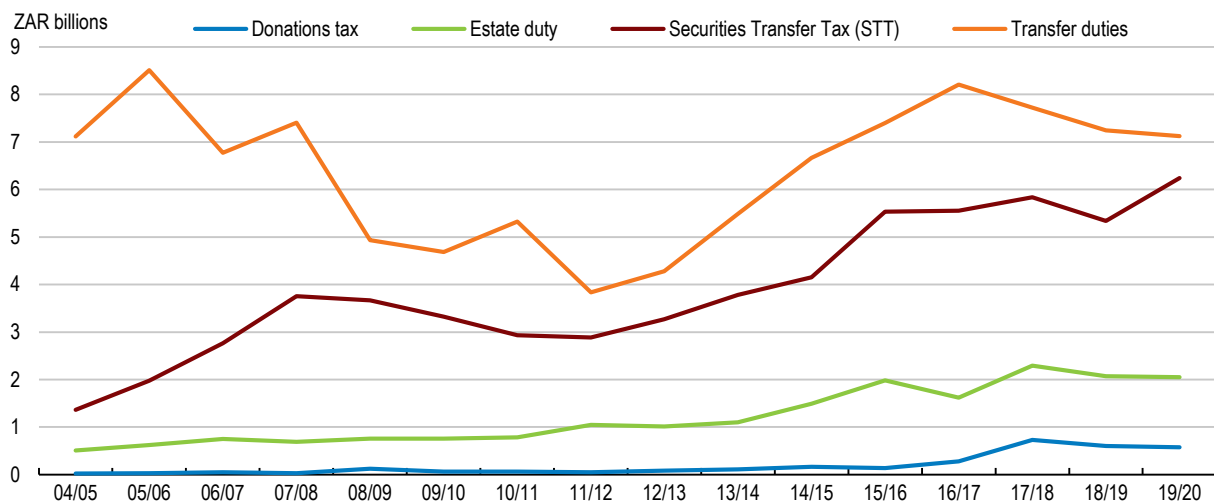
Source: OECD Revenue Statistics Database.

### Reforming wealth taxes to reduce inequalities

Wealth transmission is a major driver of inequality persistence (Loury, 1981; Fall, 2013; Mookherjee and Ray, 2002; Piketty, 2000). Estate duty is a key instrument to reduce intergenerational inequality. In South Africa, estate duty collections are particularly low, representing 0.13% of total tax revenues in 2019/20. It has increased slightly since 2018 with the introduction of a new tax bracket (Figure 23). Estate Duty is levied on the worldwide property and deemed property of a person who is ordinarily resident in South Africa and on South African property of non-residents. Various deductions are allowed to determine the net value of the estate, in particular, bequests made to qualifying public benefit organisations, and property accruing to surviving spouses – either in terms of a will or by intestate succession. All transferable benefits – including lump-sum benefits, payable from South African pension, provident and/or retirement annuity funds and trusts – are not deemed as ‘property’ and are therefore not subject to estate duty. Also, the benefits of a life insurance policy are seen as property in the estate of a deceased person, except if the policy is recoverable by the surviving spouse or child of the deceased under a duly registered ante- or post-nuptial contract for estate duty purposes and qualifying conditions regarding acquisition conditions and premium payments. An abatement of ZAR 3.5 million is allowed against the net value of the estate to determine the dutiable value of the estate. The duty is levied on the dutiable value of an estate at a rate of 20% on the first ZAR 30 million and at a rate of 25% above ZAR 30 million since 2018. Exemptions regarding life insurance, trusts and retirement savings vehicles should be reviewed and reduced as it is used to transfer financial wealth free of estate tax. Other tax avoidance loopholes and strategies that are used by the wealthy should be closed to increase the equity of the tax system in South Africa. The government could also consider reducing the ZAR 30 million threshold and introducing a second threshold with a higher tax rate.

The composition of household wealth indicates that housing assets represent only around 38% of net households’ wealth (Table 10). Financial assets represent 78% of households’ wealth. Improving the design of the estate duty, in particular by broadening its base and strengthening its enforcement, would help curb inequality transmission (Piketty and Saez, 2013).

**Figure 22. Wealth tax collections remain limited**



Source: South African Revenue Service, Tax Statistics 2020.



**Table 10. Composition of household wealth in 2018**

	Market value (R billion)	% of national income	% of net wealth
Non-financial assets	4,504	111.4	42.4
Owner-occupied housing	3,020	74.7	28.4
Tenant-occupied housing	988	24.4	9.3
Business assets	497	12.3	4.7
Financial assets	<b>8,294</b>	<b>205.1</b>	<b>78</b>
Pension assets	2,944	72.8	27.7
Life insurance assets	1,412	34.9	13.3
Bonds and interest deposits	1,798	44.5	16.9
Currency, notes, and coins	87	2.2	0.8
Corporate shares	2,053	50.8	19.3
Total liabilities	<b>2,170</b>	<b>53.7</b>	<b>20.4</b>
Mortgage debt	1,022	25.3	9.6
Non-mortgage debt	1,148	28.4	10.8
Net household wealth	<b>10,629</b>	<b>262.9</b>	<b>100</b>
Offshore wealth	575	14.2	5.4
Net wealth incl. offshore wealth	<b>11,204</b>	<b>277.1</b>	<b>105.4</b>

Note: The market value of each component is expressed in current billion rand.

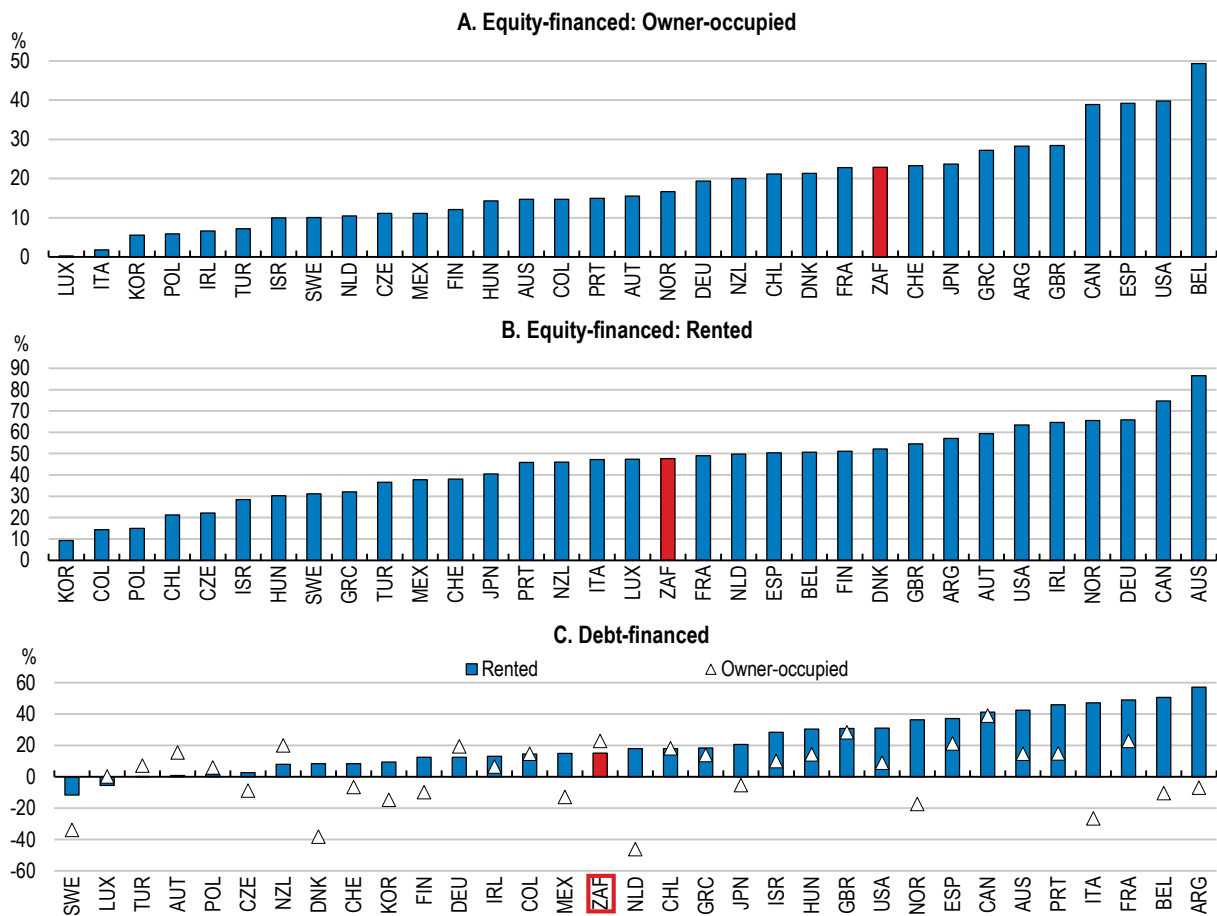
Source: Chatterjee, A., L. Czajka and A. Gethin (2020), "Estimating the distribution of household wealth in South Africa", SA-TIED Working Paper 106, UNU-WIDER

Recurrent taxation on residential immovable property is an efficient tax as it is less distortive than income tax and is difficult to avoid (Blöchliger, 2015). Municipalities have a large room to set the rates and the progressivity of the tax, and to introduce exemptions for the development of certain land areas or exclusions and rebates for low-income households. Alternatively, central government should set property tax rate bands, to avoid too low and too high rates set by municipalities. The taxing power of municipalities to set tax reductions and incentives should be limited in order to avoid *clientelism*. Properties should be valued according to guidance set by central government. The marginal effective taxation of owner-occupied residential property is equivalent whether financed through own savings or by debt and is relatively high by international standards (Figure 23, Panel A and C). The marginal effective taxation of rented equity-financed residential property is about 50%, which is relatively high by international standards (Figure 23, Panel B). However, the taxation of residential property includes several dispositions for rebates and deductions (OECD, 2018b).



**Figure 23. Marginal effective tax rates of residential property vary with the financing source**

Personal tax rate at 100% of average wage case in 2016



Note: Results assume inflation at the OECD average level; with a 20-year holding period; and the returns stemming 50% from capital gains and 50% from rent or imputed rent.

Source: Millar-Powell, B., et al. (2022), Measuring effective taxation of housing: Building the foundations for policy reform, OECD Taxation Working Papers, No. 56, OECD Publishing, Paris.

The main concern about recurrent taxation on immovable property is the valuation of properties and complaints by businesses about high rates for commercial properties. Old valuation registers should be updated and collection of taxes due be improved as noted by the Auditor General’s report. Further technical support from the national government may be required to improve capacity, for example in updating valuation registers. However, the updating of property values requires careful implementation and (possibly) be made revenue neutral, by adjusting tax rates, to avoid that higher property values result in sharp tax increases. This may raise concerns in particular for households that are cash-constrained but live in a property of high value. Updating the value of real estate properties would increase tax collections on immovable property and should be accompanied by a reduction of the transfer duty on real estate (up to 13%), which is high by international standards. The number of different categories of property should also be reviewed with a view to establishing more uniform rates, but the higher rate for vacant land should be retained. Relief could be provided to low-income older households by allowing them to defer their debt so that it is only payable when the property is sold (Blöchliger, 2015).

### Improving the efficiency of the tax administration

The South African Revenue Service (SARS) is one of the main victims of the state capture South Africa experienced recently (Judicial Commission of Inquiry in State Capture, Report One, 2022). The SARS has

been deliberately weakened by poor human resource recruitments, a dismantlement of its main units and contracts to third parties that undermined its capacity to perform its duties (Nugent Commission, 2018 and Box 3).

### Box 3. Recommendations of the Nugent Commission

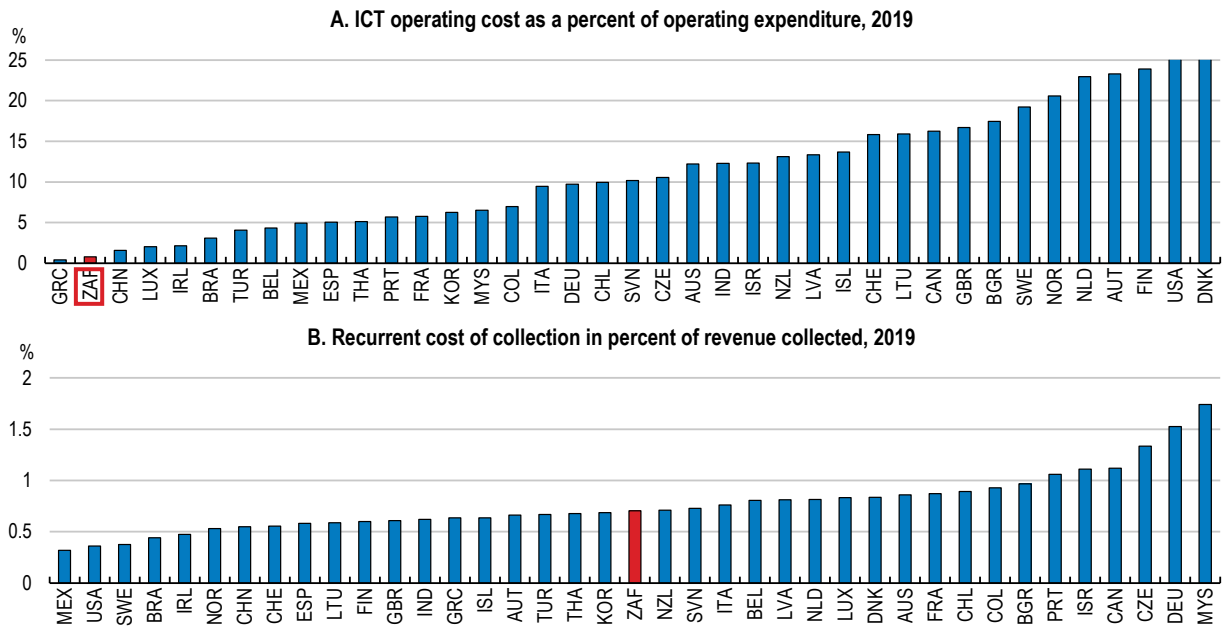
1. Appointment of the Commissioner of SARS by the President, after consultation with the Minister of Finance through a transparent process and provision in the law for the removal of the Commissioner of SARS by the President on specified grounds, through a process that is transparent.
2. Appointment of a Deputy Commissioner of SARS by the President, after consultation with the Minister of Finance, with no management line functions and appointment of an advisory Executive Committee by the Commissioner including the Deputy Commissioner.
3. Appointment of an Inspector General of SARS, capable of enquiring into possible governance failures on an ongoing basis, but with no authority to interfere directly in the operations of SARS.
4. National Treasury should review the procurement process where multiple contracts are envisaged for a project to prevent any abuse.
5. Re-establish the Large Business Centre, the Compliance Unit and establish a higher-level Integrity Unit.
6. Develop an information technology strategy and appoint a competent responsible.
7. Evaluate employees in supernumerary posts and consider their placement in suitable positions.
8. Re-establish capacity to monitor and investigate the illicit trades, in particular the trade in cigarettes, within appropriate governance structures.
9. Undertake an operational investigation to correct obstacles preventing the prompt refunding of VAT.
10. Review the terms of reference of bodies authorised to settle claims to ensure and, if necessary, strengthen governance mechanisms.
11. Review the case selection and audit protocols to ensure proper investigation of tax returns with reference to the ostensible assets of the taxpayer concerned.
12. Review debt collection contracts and determine whether they add sufficient value to SARS.
13. Restore the collaborative relations with the Prosecuting Authority, the Financial Intelligence Centre, the OECD, the Auditor-General and the National Treasury, and develop protocols for interaction with the National Treasury.

Source: Report of the Commission of Inquiry into Tax Administration at the South African Revenue Service, December 2018, <https://www.thepresidency.gov.za/download/file/fi/1466&usg=AOvVaw0za0RGFLHGrvINsWAt8Vk6>

Following recommendations of the Nugent Commission (Box 3), a new commissioner has been appointed through a transparent nomination process with a clear mandate to rebuild SARS capacity. Implementations of the Nugent recommendations have started with the re-establishment of the Integrity Unit, of the Anti-Corruption Unit, of the Large and International Business Segment (SARS, 2020b). Internal reviews were completed leading to a process to appoint a competent leadership in key positions. Procedures were reviewed to address specific challenges as the VAT refund, organised illicit activities and tax crime and internalisation of the revenue recovery. For instance, the delay for VAT refund has been decreasing in the last years (SARS, 2020b). A new strategic plan covering the 2020–2025 period has been developed (SARS, 2020c). The SARS should pursue with the implementation of the recommendations of the Nugent Commission.

To perform its mandate, the SARS is struggling with difficulties to recruit high-skilled workers and in particular specialists as international taxation or IT experts. Moreover, investments are needed to upgrade and broaden the use of information technology to benefit from the availability of more data and the development of the digital economy (Figure 24). The budget of the SARS has been decreasing in relative terms in the last years (Figure 25, Panel A). In 2021, the government increased by ZAR 3 billion the budget of the SARS for the next three years. SARS's budget should be linked to meeting objectives set in its annual performance plan. Also, the possibility to recruit foreign experts should be facilitated for specific competences that are scarce in the domestic market.

**Figure 24. The SARS compares fairly at international level**



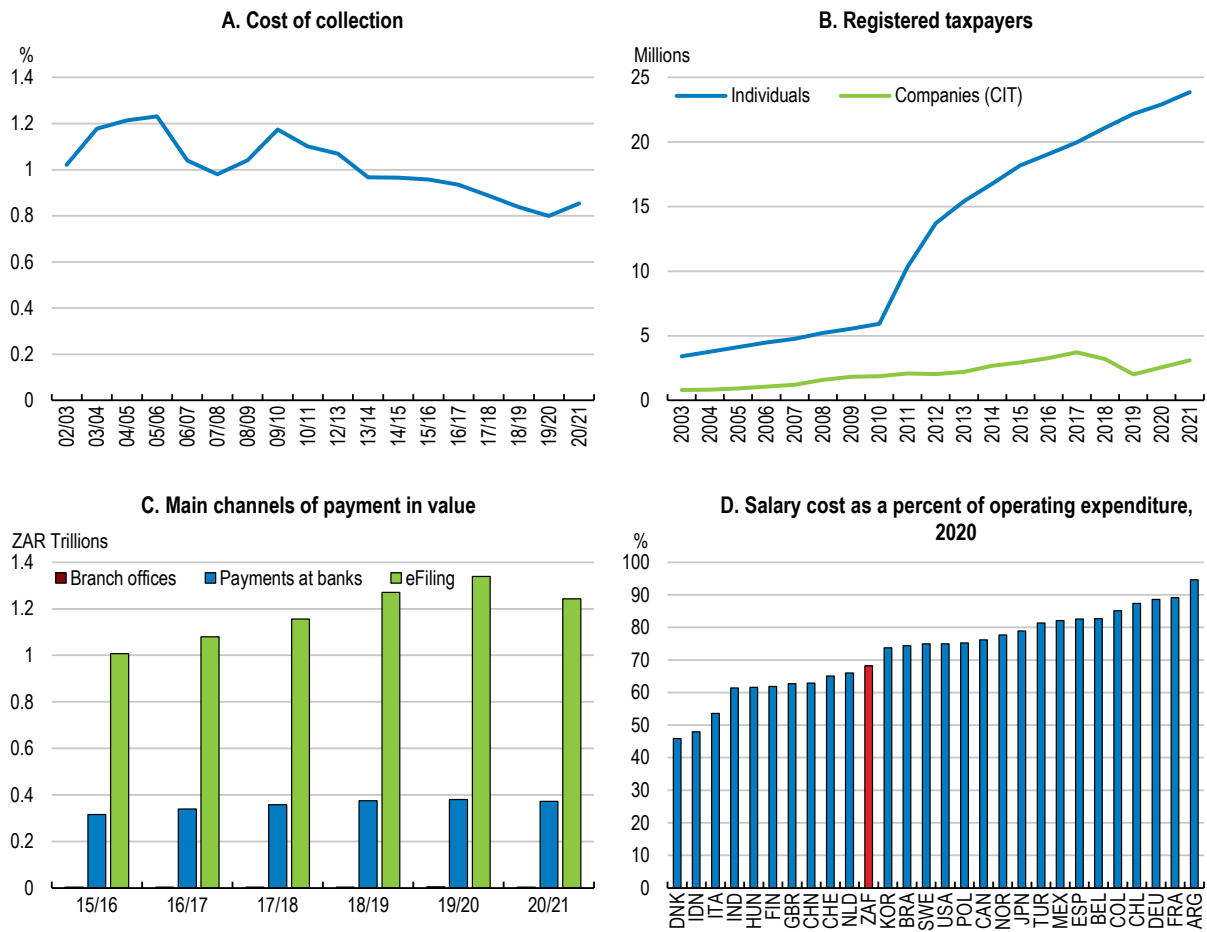
Note: To improve comparability, VAT (gross imports) has been removed from the total net revenue collected.

Source: OECD (2021), Tax Administration 2021, OECD Publishing, Paris.

Nonetheless, the SARS remains an efficient tax administration and has seen its operation costs declining in relative terms over the last decade (Figure 25). SARS had made efforts to extend the tax register, particularly for individuals (Figure 25, Panel B). Measures include retaining all employees on the tax register irrespective of their earnings levels and promoting online filing with pre-filing of returns. Since 2006/07, the share of electronic tax payment has increased and represented 81% of revenue collected in 2020.

Tax compliance could still be improved. For instance, the CIT gap as a percentage of the calculated potential current-year tax base, was close to 12% in 2017 as a result of tax evasion. Moreover, wealth taxation is subject to tax optimisation due to loopholes in the tax system with different treatments of assets (trusts, life insurance, etc.). Also, South Africa remains exposed to international tax optimisation and avoidance. The SARS has undertaken reforms to increase tax compliance by easing digital access, clarifying and simplifying legislation and forms and upgrading its information and technology systems. The SARS's strategy is focusing on developing voluntary compliance. Efforts should include compliance with international standards to ease the exchange of information with other jurisdictions and tax administrations to better track financial flows and protect the tax base.

Figure 25. The SARS has improved its performance



Note: Panel A cost of collection is in % of net total revenue collected.

Source: South African Revenue Service, Tax Statistics 2021; OECD (2022), Tax Administration 2022, OECD Publishing, Paris .

Table 11. Main findings and recommendations on strengthening the tax system

Findings	Recommendations
<b>Restore the progressivity of the personal income tax schedule</b>	
<p><b>The progressivity of the personal income tax schedule is undermined by numerous deductions, exemptions and allowances.</b></p> <p>The tax relief for pensioners is redundant with the tax deductions for pension savings.</p> <p>The medical tax credit rebate and deductions conflict with the introduction of a national public health insurance and highly benefit high income earners.</p> <p>The income tax threshold to start paying income tax is high.</p>	<p><b>Reduce tax allowances and deductions and increase the taxation of fringe benefits in the personal income tax.</b></p> <p>Abolish the tax relief for pensioners.</p> <p>Phase out progressively the medical tax credit rebates and deductions by improving the quality of the services provided by the public health.</p> <p>Lower the minimum income tax threshold</p>
<b>Broadening the corporate income tax base to reduce the tax rate</b>	
<p>CIT collections are reduced by interest deductions and assessed losses. Assessed losses represented around 20% of GDP in 2018.</p> <p><b>The corporate income rate is relatively high.</b></p> <p>The tax incentives for Small Business Corporations are not efficient in terms of additional investment and job as the cost per additional job is high.</p> <p>Tax incentives have not been successful for many sectors in terms of additional investment and jobs.</p> <p>The venture capital company tax incentive is discontinued from 30 June 2021; it has not increased investment in capital venture.</p> <p>The mining sector benefits from a generous capital depreciation scheme of 100% carried indefinitely that reduces the taxable income.</p> <p>The pillar two of the global tax introduces a minimum effective global corporate income tax set at 15% by allowing a top-up tax by countries, using an effective tax rate test.</p>	<p>Limit the carry-over of tax losses in time.</p> <p>Implement a fixed ratio rule to limit net interest deductions of foreign-owned companies to a percentage of its earnings.</p> <p><b>Reduce the corporate income tax rate while broadening the tax base.</b></p> <p>Merge the Small Business tax regime and the microbusiness regime by establishing a more progressive tax schedule.</p> <p>Replace the different regimes of capital depreciation by aligning the tax depreciation rules across sectors and capital use.</p> <p>Increase government support to venture capital through, for instance, the SA SME Fund.</p> <p>Decrease the capital depreciation allowance of the mining sector and slightly increase royalty rates.</p> <p>Review all business tax incentives on a regular basis to ensure their policy effectiveness.</p>
<b>Taxes on good and services could be raised</b>	
<p><b>The VAT rate has increased to 15% in 2018.</b></p> <p><b>The VAT is among the less distortive tax and is less regressive in South Africa than in other countries.</b></p> <p><b>VAT collection lost grounds in the last years falling from an efficient ratio of 67% in 2015 to 60% in 2018.</b></p> <p>Alcohol and tobacco consumption remains high among the adults, causing high mortality rates. Taxes on retail selling price of tobacco equates to 40% and is below WHO recommendations.</p> <p>Some trade tariffs remain high on consumer goods. These tariffs reflect industrial policy choices to encourage local manufacturing sometimes at the expense of consumers.</p>	<p><b>Raise additional revenue by raising the standard VAT rate slightly and compensate low-income households through transfers.</b></p> <p>Introduce mandatory electronic invoicing for business-to-business and business to government transactions.</p> <p>Use third-party data and cross checking to improve VAT collections and reduce non-compliance.</p> <p>Increase excise duties on tobacco and alcohol.</p> <p>Develop border controls and traceability of local productions to limit illicit cigarettes trafficking.</p> <p>Better balance the trade tariff structure between protection/incentive motivation for local industry and competition.</p>
<b>Strengthening the tax system to cope with new challenges</b>	
<p>South Africa is one of the most carbon-intensive economies. The effective carbon tax rate is low. Taxes on transport fuels represent around 40% of the fuel price and is around the OECD average.</p> <p>The VAT on cross-border e-commerce transactions turnover threshold has been increased to ZAR 1 million in 2019. The threshold is high and could reduce VAT revenues with the development of e-trade.</p>	<p><b>Reduce exemptions to the carbon tax progressively and gradually increase its level.</b></p> <p>Reduce fuel-related tax benefits for individuals and businesses and develop public transport.</p> <p>Review the turnover threshold for electronic services VAT in line with practices from advanced countries.</p>

<p>South Africa has taken considerable efforts to align its tax system with the international framework, including BEPS, and has been an active member of the International Tax Forum. Mutual Agreement Procedures are lengthy.</p>	<p>Proceed with the adjustment of the anti-money laundering legislation to close loopholes.</p> <p>Strengthen the company registry to guarantee accurate ownership information in line with international standards.</p> <p>Continue to implement the Automatic Exchange of Financial Account Information for Tax Purposes between tax administrations and evaluate whether scope exists to reform the taxes levied on capital income at the personal level, in particular dividends and capital gains.</p> <p>Ratify the Multilateral Instrument to close most of the remaining gaps in its effective dispute resolution framework.</p>
<p><b>Improving wealth taxes to reduce inequalities</b></p>	
<p><b>South Africa has one of the highest levels of wealth inequality with the top 10% holding 85% of net wealth.</b></p>	<p><b>Broaden significantly the estate tax base by reducing exemptions for life insurance, pension savings and trust vehicles as well as close other tax avoidance schemes.</b></p> <p>Reduce the ZAR 30 million estate duty threshold and consider introducing a second threshold with a higher tax rate.</p>
<p>Property taxation is hampered by the great variation in the capacity of local government, in terms of revenue collection, financial operations and service delivery.</p>	<p>Augment the assistance to municipalities to beef up their administrative capacities and update valuation registers.</p> <p>Mutualise administrative capacities between municipalities to improve the capacity to contract and deliver services.</p>
<p><b>Strengthening tax administration</b></p>	
<p>The South African Revenue Service is a victim of the state capture during past years. The budget of the SARS has been decreasing in relative terms in the last years.</p>	<p>Continue implementing the recommendations of the Nugent Commission among which:</p> <ul style="list-style-type: none"> <li>• Re-establish the Large Business Centre, the Compliance Unit and establish a higher-level Integrity Unit.</li> <li>• Re-establish capacity to monitor and investigate the illicit trades, in particular the trade in cigarettes, within appropriate governance structures.</li> </ul> <p>Increase SARS's budget progressively and link it to performance.</p> <p>Facilitate the recruitment of foreign experts for specific competences.</p>

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