CHAPTER 7

Enhancing Domestic Resource Mobilisation for Effective Rural Development and Growth: The Role of Provinces Taxation

Thando Ngozo

Enhancing Domestic Resource Mobilisation for Effective Rural Development and Growth: The Role of Provinces Taxation

7.1 Introduction

The New Growth Path and the National Development Plan outline programmes to overcome income and asset poverty, chronic unemployment and food insecurity in rural areas. These policy documents state clearly that multiple interventions are needed over the next two decades in order to place rural areas on more sustainable development paths. They advocate for both farm and non-farm rural employment, the creation of a broad suite of green economy initiatives in rural areas and the delivery of rural services.

The meaning of rural development varies but, essentially, it is about addressing poverty and improving the quality of life for people living in rural areas. The democratic government that came to power in 1994 inherited poverty-stricken rural areas characterised by overcrowding and underdevelopment (May, 2000). Therefore, the agenda of the new government included redressing the past to improve the living standards of the majority who were living in poverty and who mostly resided in rural areas (Kole, 2005). This was reflected in various government development policy documents, programmes and strategies that have been developed since 1994 (Gwanya, 2010; Kole, 2005).

The funding of rural development is intertwined with fiscal design. Theoretically, subnational governments should provide constituents with services whose cost is equal to the benefit (i.e. the value of the services). This can only happen if subnational governments have the authority and are in a financial position to raise their own taxes. This means decentralised revenue policy, which relates to three dimensions: the assignment of revenue sources to government spheres, the degree of autonomy with which subnational governments can exercise their assigned authority, and the efficiency of the revenue administration system.

In South Africa, the intergovernmental system is sound, but concurrent functions occasionally present particular challenges and test the system's robustness. The sometimes imperfect alignment between policy-making and resource allocation results in a divergence between policy intentions and actual outcomes. Therefore, budgets provide an important connection between policy objectives and policy outcomes. Policies that are not funded or are inadequately funded are hardly implemented, and their objectives are therefore not properly realised.

The performance of the intergovernmental system in general, and provinces in particular, is important in improving the quality of life of South Africans. According to Schedule 4 (Part A) of the Constitution, rural development is a concurrent responsibility of national and provincial governments. Therefore, provinces should play a crucial role in rural development. National transfers (the provincial equitable share (PES) and conditional grants) comprise the largest share of funding for services delivered by provinces, while provincial own revenue remains a small portion of total provincial revenue.

The main objectives of this chapter are

- To explore the scope for increasing provincial own-revenue streams.
- To investigate the drivers behind the decline of own revenue in rural provinces and the necessary remedial actions needed to stem the tide.
- To determine whether the lack of accountability for spending provincial fiscal transfers represents a moral hazard problem, and if yes, how it can be rectified.
- To examine the shared tax base model as a viable alternative for provinces.

7.1.1 Overview and problem statement

Provinces receive three forms of revenue: the PES, provincial conditional grants and own revenue. They have limited revenue-raising powers and so collect insignificant own revenues. In 2014/15, own revenues accounted for just 3% of provincial budgets and are projected to decline to 2.9% in 2016/17. National transfers are also likely to remain stagnant or decline because of fiscal constraints, and so transfers to provinces will grow more slowly in the future. It is worth noting that own income is healthy in urban provinces but declining in rural provinces. For instance, between 2013/14 and 2016/17, the annual average growth rate of own revenue was -7.2% in the Eastern Cape compared to 3.4% in Gauteng. Therefore, the potential of increasing provincial own revenues (particulary in rural provinces) needs to be explored.

7.1.2 Cogent reasons for assessing provincial own revenue

The literature (and indeed practice) is filled with studies and experiences that point to some obvious drawbacks of taxes in general (Stiglitz, 1999) and a lack of interest on the part of authorities in raising taxes. It is well known that most forms of taxation impose economic costs by distorting decisions on such matters as whether to incorporate (or become informal), the debt-equity ratio, dividend policy, and where and how much to invest. The economic case against taxes seems even stronger at the subnational level than at the national level. Some of the reasons identified include:

- Resource mobility is higher across provincial and regional boundaries than national boundaries.
- Provincial budgeting is difficult because of the unpredictability of the tax yield.
- The national government's scope for increasing national tax rates is restricted if provincial tax rates combined with local and national taxes exceed a certain desirable magnitude.
- Cross-border shopping poses problems, as it weakens accountability (since some provincial taxes would be paid by non-residents) and potentially result in suboptimal tax rates ("race to the bottom" hypothesis).
- Agents have to carry a compliance burden, especially where frequent changes require stock repricing or where businesses supply customers who are located in many different areas.

The Commission argues that own revenue is important for funding rural development, in particular because of two reasons.

- It reduces dependence on grants and fosters accountability. The overall system of provincial government finance is generally unsatisfactory. Subnational governments that rely on own-revenue sources (rather than grants) are more responsive to the needs of residents and businesses, and to the overall long-term needs of the province. Provincial own revenue removes the negative implications inherent in grant financing, which places substantial power in the hands of individual national officials able to influence the continuing grant flow and removes responsibility from provincial governments since they can legitimately argue that the feasibility of delivering services is dependent on national government rather than the province itself. Additional own tax is attractive for two reasons: (a) The burden of paying for additional local spending is spread across more than one tax base, and so the provincial tax burden is distributed more fairly, across taxpayers and (b) a reduction in gearing might help to reduce the influence of central government over provincial government, by reducing the percentage increase in own taxes following any given percentage change in budget or grant.
- It fosters efficiency. Provincial taxation will incentivise the rural province to act in ways which expand the local economy. In so doing, the tax base will be expanded and thus the revenues of the province will grow, offering scope for further improvements and further growth. Implicitly the argument here is that "nationalising" parts of provincial own revenue has left provincial governments with little incentive to attract province-specific economic activity; reintroducing some form of provincial taxation might help restore a better mutual awareness between business and provincial government. The counter argument is that this premise is false because provincial government has not sought to attract business using existing instruments, such as charges/surcharges on services, development and tourism. Nevertheless, in the current context, what is needed is careful consideration of whether a rural tax would be a better way of fostering the relationship between provincial government and business than the alternative handles that are already available.

7.1.3 Constitutional revenue-raising powers for provinces

The revenue system in South Africa is based on the principles of uniformity, harmony, and efficiency, although the assignment of revenue functions involves lower fiscal autonomy for subnational governments. All broad-based taxes are assigned to the national government, while narrow-based taxes are assigned to provincial authorities (Khumalo and Rao, 2004).

According to Section 228(1) of the Constitution, provinces have the right to levy certain taxes and surcharges, i.e. flat-rate surcharges on any tax, levy or duty that is imposed by national legislation, except for corporate income tax, value-added tax (VAT), excise levies or property taxes (Mabugu et al., 2009). Provinces may impose these taxes provided they do not prejudice national economic policies, economic activities across provincial boundaries and national goods and services or factor mobility (Ajam, 2006). No province has exercised its taxation or surcharge powers. The Constitution gives provinces some leeway to augment own revenues but fails to provide specific details of other tax bases on which provinces could impose levies or surcharges.

7.2 Literature Review on Subnational Taxes Applicable to Provinces

The literature suggests that the following sources of own revenues are available to provinces: automotive and fuel taxation, surcharges on a nationally uniform personal income tax (PIT), a provincial value added tax (VAT) and a business value tax (BVT).

7.2.1 Vehicle-related taxes

The potential of vehicle-related taxes at subnational level could be exploited more fully (Bahl and Linn, 1992). From a revenue perspective, the fuel tax is the most important tax and the simplest and cheapest form of vehicle tax to administer. Provinces could choose to impose different taxes, but the constraint would be the inability to differentiate much from the rates imposed by neighbouring provinces owing to the mobility of the tax base (ibid).

The subnational taxation of motor vehicles is often designed and implemented poorly, but it remains a fundamentally good tax for provinces. The design of any vehicle taxation system needs to be carefully considered (Smith, 1991), particularly in developing countries, to avoid repeating the mistakes of most developed countries and to achieve more revenue and better economic effects. Provincial revenues could be increased by allowing provincial governments some access to the fuel tax and allowing them to impose variable provincial surcharges. Vehicle and fuel taxation seems to be the only universally available subnational revenue source that exhibits more than unitary income-elasticity, thereby matching this aspect of some of the key services (such as education and health) for which provincial governments are responsible.

7.2.2 Personal income taxes

Canada and Scandinavia provide evidence of supplementary subnational PITs that can increase provincial own revenues, so that provinces can expand their activities or become more self-reliant. A subnational PIT is visible and so enhances greater political responsibility and accountability. The Nordic countries (Denmark, Finland, Norway, Sweden), where subnational governments have large expenditure roles and are mostly fiscally autonomous, offer the best-known examples of subnational income taxes. These subnational income taxes are basically levied at a flat, subnationally determined rate on the same tax base as the national income tax and collected by the central government (Soderstrom, 1991).

In most developing countries, subnational income taxation does not exist because (in most instances) of the rationale that central governments prefer to collect income tax themselves. And yet the reality is that even central governments appear to find it difficult to collect much from income tax (Bird and Zolt, 2005).

In practice, a subnational PIT could reach the same tax base as a subnational payroll tax. However, subnational PITs have to be linked to specific employees and so would be more costly to administer. Although a provincial payroll tax should be considered as a possible revenue source in large emerging countries, surcharges on a nationally uniform PIT base are in principle a more appropriate way for subnational governments to tax wages.

7.2.3 General consumption taxes (VAT)

A subnational revenue source, which is economically respectable, administratively viable and broad based with reasonable elasticity, is a general sales tax, which in most countries takes the form of VAT.

The dominance of VAT poses a serious problem for the finances of subnational governments (Keen and Lockwood, 2006). The conventional consensus is that a central VAT is the only good VAT and subnational VATs are either unfeasible or undesirable for a variety of reasons, such as high administrative and compliance costs, the possible loss of macroeconomic control, the general reluctance of central governments to share VAT room, and the problems arising from cross-border and inter-provincial trade (ibid). However, a well-functioning, destination-based, subnational VAT is now in existence in Canada (Bird et al., 2006). The Canadian experience shows that with good tax administration, a destination-based, subnational VAT at provincial level is perfectly feasible. However, a common base is highly desirable and a single administration is clearly more efficient, while a high degree of intergovernmental trust is required if the system is to work efficiently.

In terms of accountability, a subnational PIT appears preferable to a subnational VAT in most respects. However, in most countries, enforcing effective PITs is a challenge, and so an effective VAT could be an important additional way to strengthen regional tax revenues, especially when provincial governments have large spending responsibilities that require them to have control of, and responsibility for, some major revenue sources.

7.2.4 Business taxes (BVT)

Another important source of subnational tax is business taxes, which include corporate income taxes, capital taxes, non-residential property taxes, as well as ancient levies and various forms of industry and commerce taxes. Subnational business taxes often produce substantial revenue and are more elastic than property taxes.

Experience in both developed and developing countries suggests that some form of business taxation is generally

the most elastic source of revenue at subnational level. However, estimating the incidence of such taxes is difficult because of the assumption that they are paid by someone other than local residents. Where possible, subnational governments are inevitably tempted to impose taxes on someone else, rather than to increase the home, income or consumption taxes of their citizen-voters.

Tax experts are not enthusiastic about subnational business taxes because their impact is not well understood, and the evidence in most countries appears to be that business taxes usually exceed business benefits (McLure, 1994). Therefore, the main question is how subnational governments can realise the potential virtues of subnational business taxation (an essentially elastic revenue source that provides increased autonomy), while minimising problems, such as economic distortions, high administrative costs and exporting benefit taxes to non-residents. One answer is to impose a BVT. Businesses add value by combining labour and capital with other purchased inputs. The value added by labour is the cost of labour (wages and salaries), while the value added by capital is the cost of capital (both debt and equity). The tax base would consist of revenues less purchases of inputs (except labour).

Compared to a conventional value-added tax (VAT), a BVT has three important distinguishing features:

- It is a tax on income, not consumption, and so is imposed on profits as well as wages, i.e. on both investment and consumption.
- It is a tax on production, not consumption, and so is imposed on an origin rather than a destination basis, i.e. in effect it taxes exports, not imports.
- It would be assessed on the basis of accounting records (or equivalent estimates) rather than on a transaction basis and collected annually (or by periodic payments) based on an annual assessment.

Studies have highlighted that badly designed and implemented local business taxation systems can be a barrier to the growth of micro and small enterprises (World Bank, 2007). The BVT offers a potential solution to this problem and to local government revenue problems, particularly in large and expanding urban areas, and so deserves more detailed examination in many emerging countries.

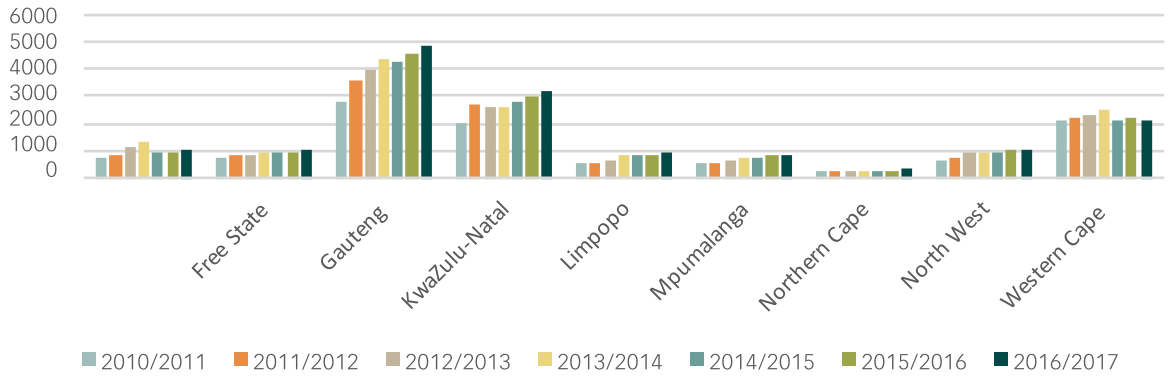
7.3 Provincial Own-Revenue Analysis[37]

7.3.1 Provincial own revenues by province

Between 2010/11 and 2016/17, Gauteng, KwaZulu-Natal and Western Cape consistently generated more own revenues than the other six provinces (Figure 63). In 2010/11, Gauteng generated R2.8-billion in own revenues, or 28% of total provincial own revenues, followed by Western Cape (R2-billion or 20%) and KwaZulu-Natal (R1.9-billion or 19%). The provinces that generated the least own revenues were the Northern Cape (R213-million or 2%), Mpumalanga (R528-million or 5.1%) and Limpopo (R551-million or 5.4%).

Medium-term projections show that, in 2016/17, Gauteng will continue to generate the highest amount of own revenue (R4.8-billion, or 32% of total provincial own revenues), followed by KwaZulu-Natal (R3.1-billion or 21%) and the Western Cape (R2.1-billion or 14%). The projections also show that the Northern Cape will continue to generate the least own revenue (R313-million or 2%) followed by Mpumalanga (R838-million or 5%) and Limpopo (R919-million or 6%).

Figure 63. Provincial own revenue (2010/11–2016/17)



Source: National Treasury

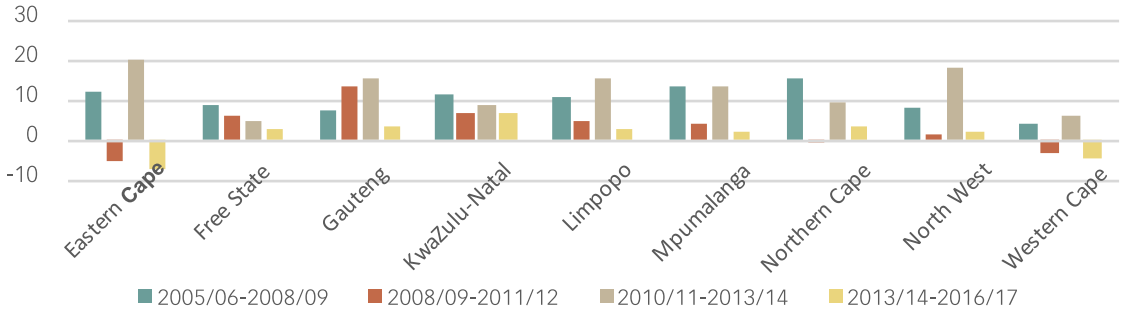
>>

[37] All the data in this section has been sourced from National Treasury's provincial database

7.3.2 Growth in provincial own revenues

The growth in own revenue shows a mixed picture across provinces (Figure 64).

Figure 64. Growth in own revenue (2005/06–2016/17)



Source: National Treasury

The analysis of annual percentage growth in provincial own revenues show that own revenues have generally been declining and the projections show a further decline for the medium term. Between 2005/06 and 2008/09, percentage growth in provincial own revenue was 8.6%, it decelerated to 4.9% between 2008/09 and 2011/12 before increasing to 12.5% between 2010/11 and 2013/14. Between 2013/14 and 2016/17 the percentage growth in provincial own revenue is projected to decrease substantially to a mere 1.8%. This is mainly attributed to the fact that while provinces are responsible for functions that account for a large share of government spending, they have limited revenue-raising opportunities. The decline may also be attributed to strong growth in national transfers to provinces. Provinces also prefer not to commit their projected own revenues in their budgets and like to use over-collections as in-year discretionary funding.

The differential analysis of annual percentage growth by provinces shows a mixed picture. The analysis show that for some periods, rural provinces were able to record higher annual percentage growth in own-revenues than urban provinces reflecting higher efficiencies in their own-revenue collection mechanisms. While the Northern Cape and Mpumalanga generated the least own revenues between 2005/06 and 2008/09, they recorded the highest percentage growth in own revenues over the same period. This could potentially suggest their higher efficiency in own revenue collections when compared with the other provinces, notwithstanding their rurality. However, the picture changed between 2008/09 and 2011/12, as Gauteng and KwaZulu-Natal, predominantly urban provinces, recorded the highest percentage growth in own revenues over this period. This suggests that not only did these provinces generate more own revenues but they were also more efficient in doing so when compared with other provinces over this period. Between 2010/11 and 2013/14, the Eastern Cape and North West, largely rural provinces, recorded the highest percentage growth in provincial own revenues even though they generated the least revenue compared with the urban provinces. This suggests that over this period these provinces were more efficient in own revenue collection when compared with other provinces. Between 2013/14 and 2016/17, KwaZulu-Natal and Gauteng, effectively urban provinces, are projected to record the highest percentage growth in provincial own revenues, suggesting more efficiency in their own revenue collection than the other provinces.

7.3.3 Composition of provincial own revenues

Provinces generate their own revenues from tax receipts (casino taxes, horse racing taxes, liquor licences and motor vehicle licences). In 2016/17, tax receipts are expected to account for 70.1% of provincial own revenue, having increased from 49.5% to 64.5% between 2001/02 and 2013/14. Motor vehicle licence fees are the most significant source of own revenues for provinces, followed by casino tax, horse racing tax and liquor licence taxes (Figure 65).

Figure 65. Provincial own revenue by category (2001/02–2016/17)

Source: National Treasury

Motor vehicle taxes

Historically motor vehicle licences have been the major source of provincial own tax revenue in South Africa. As Figure 65 shows, motor vehicle licences represented over half total provincial own revenue in 2015/16, but the growth has remained fairly stagnant over the past 15 years, growing by an average 2.5% per year. Thus the most important source of provincial own revenue records only moderate growth.

Between 2005/06 and 2014/15, motor vehicle licences represented 89% of the provincial own revenue in the Free State, 86% in the Northern Cape, 85% in Limpopo and 83% in Mpumalanga, compared to 73% in the Western Cape and 74% in Gauteng and KwaZulu-Natal.

Casino tax

Tax from casinos is the second most important source of own revenues for provinces, representing 13.1% of total own revenue in 2014/15. This share is expected to rise to 13.9% by 2016/17. The average annual percentage growth of casino tax was 8.61% between 2001/02 and 2007/08, but decelerated significantly to -0.31% between 2008/09 and 2013/14 before recovering marginally to 2.01% between 2014/15 and 2016/17. This means that the second major source of provincial own revenue is mostly experiencing negative growth.

Between 2005/06 and 2014/15, casino licence taxes made up 24.3% of Gauteng's own revenues, the highest share of all provinces, followed closely by the Western Cape (24%), the North West (21.9%) and KwaZulu-Natal (21.5%). In contrast, casino licence taxes contributed just 8% of provincial own revenue in the Free State, 10% in Limpopo and 12% in the Northern Cape.

Horse racing tax

Horse racing tax, the third major source of provincial own tax revenue, contributes less than 2% to total provincial own revenue, having decreased from 3.1% in 2001/02. However, in terms of average annual percentage growth, horse racing taxes increased by 0.57% between 2008/09 and 2013/14 and 14.67% between 2014/15 and 2016/17. This means that the third major source of provincial own revenues has, on the main, been marginally increasing.

Between 2005/06 and 2014/15, horse racing taxes represented an average of 6% of the North West's total own revenue, followed by KwaZulu-Natal (4%), Limpopo (3%) and the Western Cape (2%). In the Northern Cape, the horse racing tax contributed an average of 0.61% to provincial own revenue, compared to 1.59% in Gauteng and 1.76% in the Eastern Cape.

Liquor licences tax

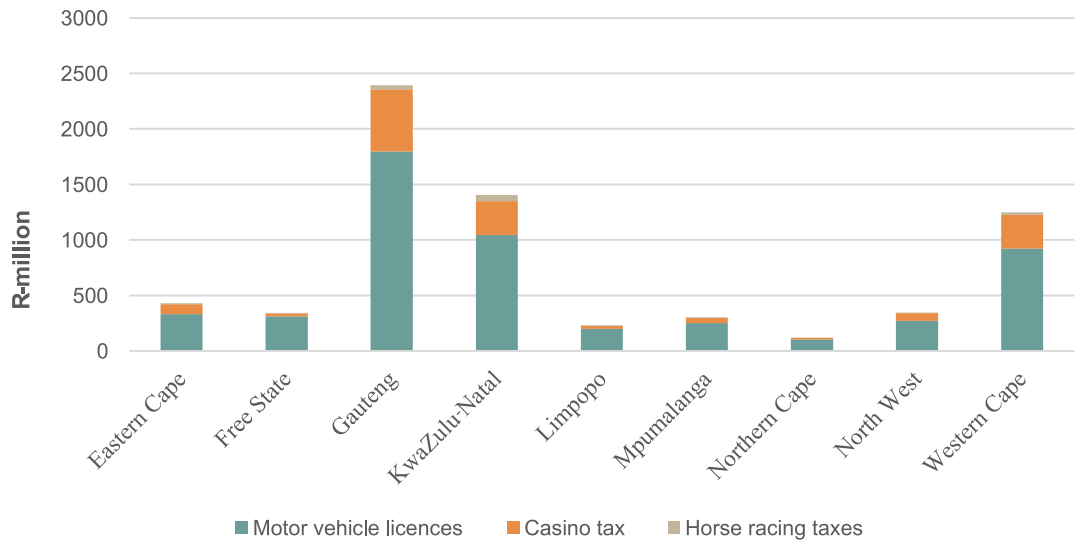
The fourth major source of provincial own tax revenue is the liquor licensing tax, which represents 1% of total provincial own revenues. It has remained stagnant over the past 15 years and did not grow (growth of 0%) between 2014/15 and 2016/17. The differential analysis of liquor licences tax by province could not be carried out due to lack of data.

7.3.4 Differential analysis of the composition of own revenues by province

As Figure 66 shows, Gauteng, KwaZulu-Natal and the Western Cape collect more motor vehicle licensing and casino taxes than the Northern Cape, Limpopo and Mpumalanga. Between 2005/06 and 2014/15, Gauteng collected R17.9-billion in motor vehicles licence taxes and R5-billion in casino taxes, followed by KwaZulu-Natal (R10.4-billion and R3.05-billion) and the Western Cape (R9.2-billion and R3.02-billion), whereas the Northern Cape collected R1.04-billion and R142-million in motor vehicle licence and casino taxes respectively.

A slightly different picture emerges for horse racing taxes, with KwaZulu-Natal collecting R5.4-billion, Gautent R3.76-billion and the Western Cape R2.45-billion.

Figure 66. Own-revenue composition (2005/06–2014/15)



Source: National Treasury (2015a)

7.3.5 Poverty levels and own revenues

The highest poverty levels are in Limpopo, where in 2011 almost two-thirds (63.8%) of all residents were poor, followed by the Eastern Cape (60.8%) and KwaZulu-Natal (56.2%). These three provinces are also home to the largest share of South Africa's poor people: in 2011, more than a quarter (26.3%) of all poor people lived in KwaZulu-Natal, followed by Eastern Cape (18.3%) and Limpopo (16.1%). Their share of the poor has been increasing since 2006, by 4% in KwaZulu-Natal and Eastern Cape and 9% in Limpopo.

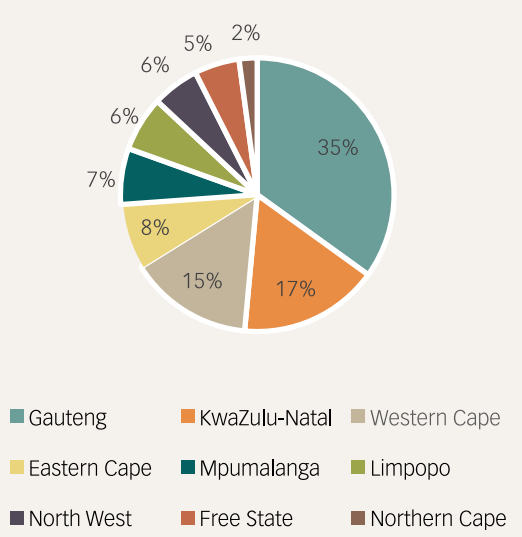
In 2011, Gauteng had the lowest number of individuals living below the poverty line but was home to the fourth highest percentage (11%) of poor people in South Africa. The Northern Cape had a poverty headcount of 46.8%, but the province's small population meant that only 1.8% of the country's poor lived there. Between 2006 and 2011, the number of individuals living below the poverty line reduced the most in the Western Cape and Gauteng, by 33% and 29% respectively, and the least in the Eastern Cape (13%) and Limpopo (14%).

Limpopo and the Eastern Cape have high levels of poverty and generate very low own revenues when compared with the other six provinces, implying that high poverty levels are associated with low own revenues. However, KwaZulu-Natal is an exception to this trend, as the province experiences high levels of poverty but generates more own revenues than most provinces.

7.3.6 Provincial economic activity and own revenues

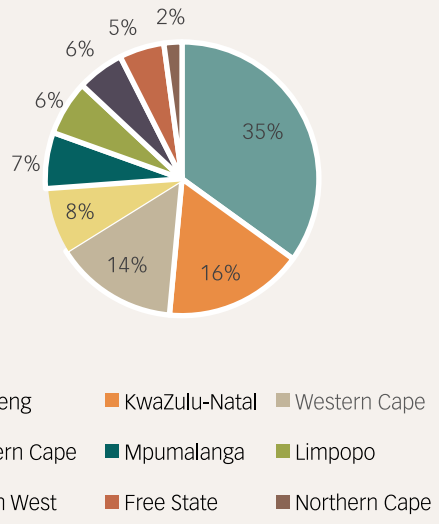
Economic activity in South Africa remains highly concentrated in a few provinces. Between 2004 and 2014, Gauteng, KwaZulu-Natal and the Western Cape accounted for more than 64% of national GDP. As Figures 67 and 68 show, the GDP share by provinces changed little during this period, with Gauteng consistently contributing 35%, followed by KwaZulu-Natal (17% in 2004 and 16% in 2014) and the Western Cape (15% in 2004 and 14% in 2014). These three provinces also generate more own revenues than the other provinces, suggesting a strong relationship between economic activity and own-revenue generation.

Figure 67. GDP share by province (2004)



Source: IHS Global Insight Regional (2015)

Figure 68. GDP share by province (2014)



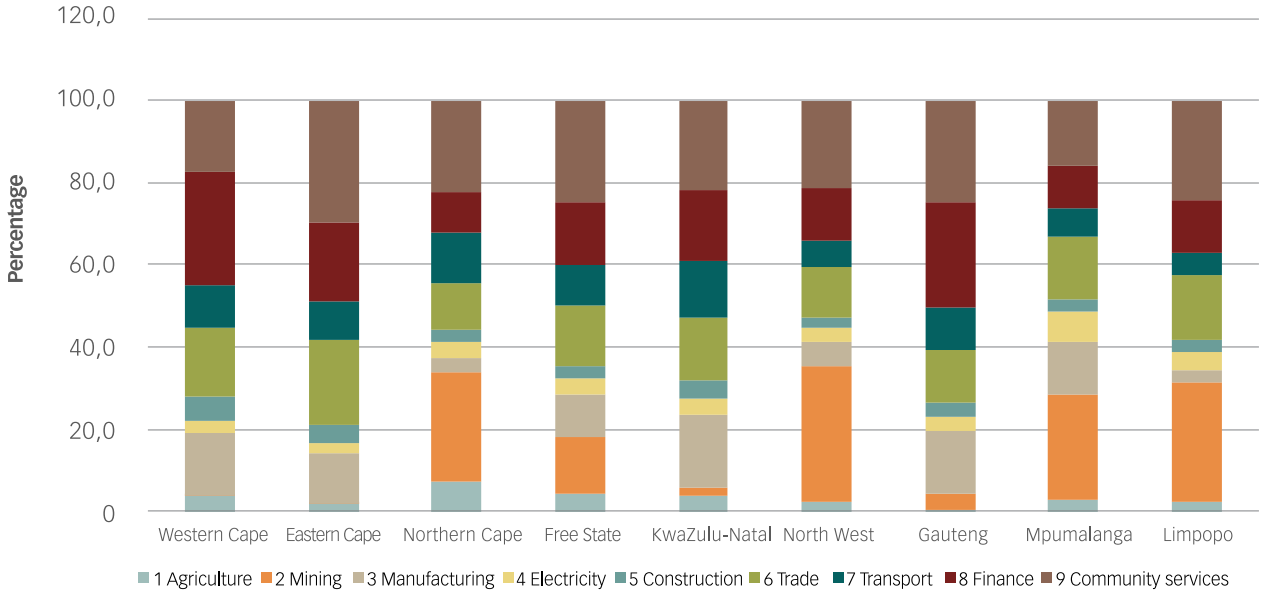
Source: IHS Global Insight Regional (2015)

7.3.7 Provincial sectoral analysis and own revenues

As Figure 69 shows, in provinces, the largest sectors are community services, finance, trade, mining and manufacturing, which together account for 79% of South Africa's GDP. Community services represent at least 20% of provincial GDP except for in the Western Cape and Mpumalanga, while finance is important for the Western Cape and Gauteng. Trade occupies a larger share of the Eastern Cape's GDP than in any other province, mining makes up between 25% and 33% of GDP in four provinces – the Northern Cape, North West, Mpumalanga and Limpopo – while manufacturing represents over 15% of the GDP in the Western Cape, KwaZulu-Natal and Gauteng.

The finance sector is highly concentrated in the Western Cape, Gauteng, the Eastern Cape and KwaZulu-Natal while manufacturing is moderately concentrated in the same provinces. The analysis shows that these provinces generate more own revenues than the other six provinces with the exception of Eastern Cape. This means that the finance and manufacturing sectors are important sectors for the generation of provincial own revenues.

Figure 69. Sector share of GDP by province (2014)



Source: IHS Global Insight Regional (2015)

7.3.8 Conditional grants vs. own revenues

Conditional grants have consistently grown more than own revenues: between 2001/02 and 2004/05, conditional grants grew at an average annual growth rate of 24% compared to only 8.7% in own revenue. Between 2005/06 and 2008/09, conditional grants grew at an average annual growth rate of 30% compared to only 8.9% in own revenue. Between 2009/10 and 2012/13, conditional grants grew at an average annual growth rate of 15% compared to 11.8% in own revenue. Between 2013/14 and 2016/17, conditional grants are projected to increase at an average annual growth rate of 8% compared to 4.5% in own revenue. This inverse relationship between the growth of conditional grants and own revenues suggests a lack of fiscal effort by provinces to generate own revenues.

Between 2001/02 and 2014/15, conditional grants to Gauteng grew by an average annual rate of 48%, much higher than the growth found in other provinces, i.e. the Free State (31%), Mpumalanga (27%), the Northern Cape (22%), KwaZulu-Natal (18%), the Eastern Cape (16%), the Western Cape (14%) and the North West (12%). The variations in annual percentage growth of conditional grants could be attributed to different frameworks for the different grants as well as the different needs of grant-specific programmes in each province. While Gauteng generated a higher percentage of own revenue (28% of total provincial own revenues), Mpumalanga (5.1%) and the Northern Cape (2%), generated the least. This suggests that in Mpumalanga and the Northern Cape, the high annual percentage growth in conditional grants is associated with low generation of own revenue.

The concentration of economic activity and sectoral analysis reveals that urban provinces with high economic activity also collect more own revenues. The finance and manufacturing sectors are important sectors for the generation of provincial own revenues. Therefore, the lack of concentrated economic activity and the underdevelopment of the finance and manufacturing sectors constitute a third constraint for rural provinces in the generation of own revenues. However, the Eastern Cape is an outlier with regards to the finance sector.

7.4 Methodology

7.4.1 Background to the methodological approach

As stated earlier, provincial governments rely heavily on national transfers because they have very limited revenue sources, as most tax bases are delegated to the national government. At the same time, provincial governments are responsible for promoting rural development and meeting the population's demand for quality public services. These responsibilities will increase in tandem with education levels. Therefore, this mismatch between limited revenue and increasing expenditures for rural development will eventually translate into a widening deficit in the provincial governments' fiscal balance.

Two plausible solutions are available to meet this challenge: either devolve more tax revenues to provincial governments or increase the amount of central government transfers. However, an in-depth analysis is first needed into how well provincial governments are using their tax bases. The fiscal effort exerted by the provincial governments is analysed using the representative tax system (RTS) approach. The objective of comparing the fiscal effort of different provinces is to establish what limits the provincial revenue collection: the tax base or the reluctance of provinces to optimise revenue collection.

7.4.2 The representative tax system methodology

The RTS approach quantifies the disparities across provinces. It measures the revenue-raising ability of each province by applying a standard tax rate on available tax bases. Comparing actual revenue collections to potential revenue collections, and indexing these to the national average, creates the fiscal effort index. This shows the extent to which provinces are maximising their potential revenue from current revenue sources – their "tax effort", which measures the amount of revenue collected by a province relative to what could reasonably be collected given the tax base. The ratio of actual to potential tax revenue serves as an index for fiscal effort (Bahl, 1972; Tait and Echingreen, 1978; Tanzi (1981).

The methodological approach consists of five steps:

Step 1:

The major provincial tax revenue sources used are own revenue and their respective tax bases. [38]

Step 2:

An average tax rate is estimated:

$$tjy = \frac{\sum_{i=1}^{4} Tijy}{\sum_{i=1}^{4} TBijy} \quad (1)$$

Where tjy = national average tax rate source j $(j=1 \text{ to } n)$ in year y

$\sum_{(i=1)}^{4} Tijy$ = Sum of tax revenue of all provinces from source j in year y

$\sum_{(i=1)}^{4} TBijy$ = Sum of tax base of all provinces for revenue source j in year y

Step 3:

The average tax rate is applied to respective tax bases to calculate provincial potential tax revenue for each source j:

$$PTR_{ijy} = t_{jy} \; x \; TB_{ijy} \quad (2)$$

Where

PTR_{ijy} = potential tax revenue of province i from resource j in year y

TB_{ijy} = tax base of province i for source j in year y

Step 4:

An index for fiscal effort (IFE_{IJY}) is constructed, for tax revenue of province i from source j in year y:

$$IFE_{ijy} = \frac{Tijy}{PTRijy} \quad (3)$$

Step 5:

An overall index for fiscal effort $(OIFE_{iy})$ is constructed for province i

$$OIFE = \frac{\sum_{j=1}^{n} Tijy}{\sum_{j=1}^{n} PTRij} \quad (4)$$

Where

$\sum_{j=1}^{n} Tijy$ = Sum of tax revenues of a province i from all sources $(j=1 \text{ to } n)$ in year y

$\sum_{j=1}^{n} PTRijy$ = Sum of potential revenues of province i from all sources in year y.

>>

[38] See Appendix for the specific tax revenue sources and their respective tax bases.

7.4.3 Data analysis and construction of indices for fiscal effort

The above methodology is used to construct the following indices:

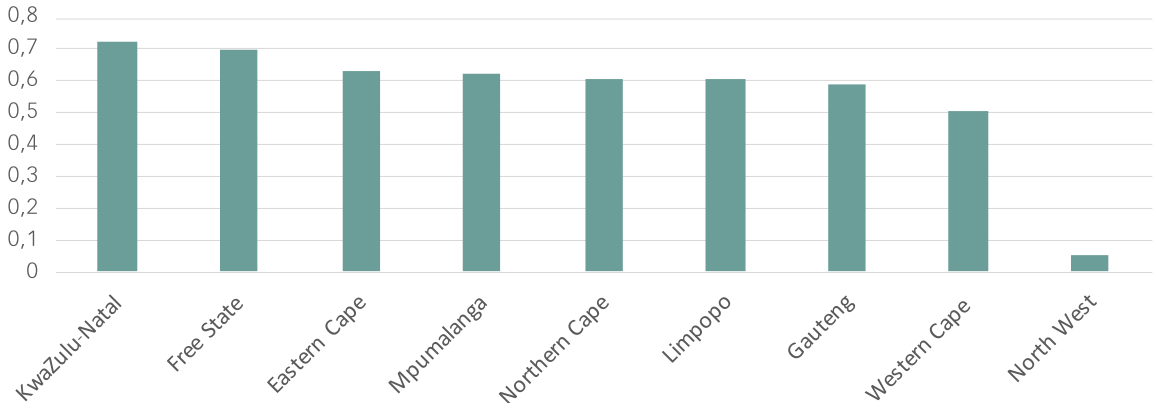
- Provincial fiscal effort indices for individual taxes
- Overall indices for fiscal effort for all provinces

The benchmarks used in these indices are merely national averages, and so are not necessarily proven optimal levels nor necessarily desirable. Therefore, it would be distorting to interpret that above one or above-average reflect disproportionately more fiscal effort, or those less than one or below-average reflect an unacceptably low fiscal effort.

7.4.4 Results and discussion

Figure 70 shows the results for fiscal effort in 2005. KwaZulu-Natal had the highest fiscal effort (0.7268), followed by Free State (0.7028), Eastern Cape (0.6347) and Mpumalanga (0.6212). North West, Western Cape and Gauteng had the lowest fiscal effort, at 0.0538, 0.5085 and 0.5919 respectively.

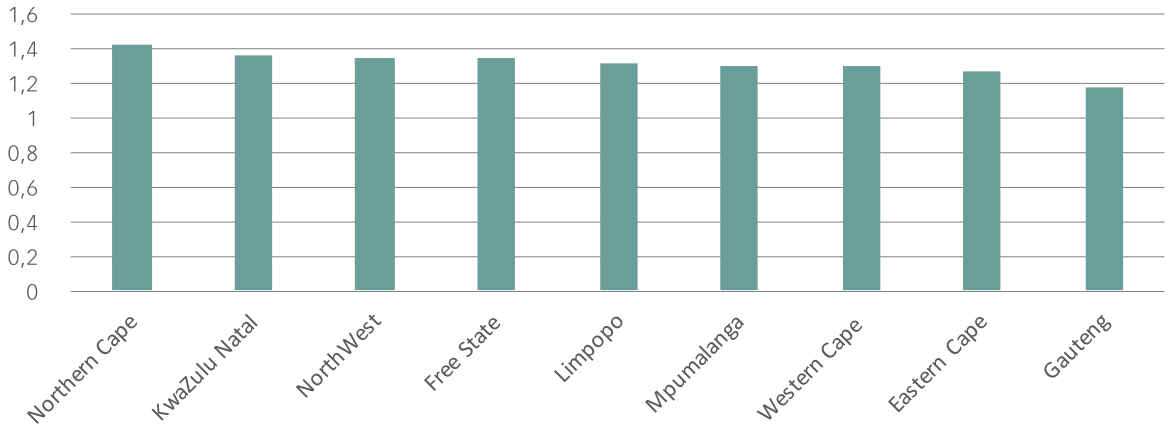
Figure 70. Overall index for fiscal effort (2005)



Source: Author's calculations

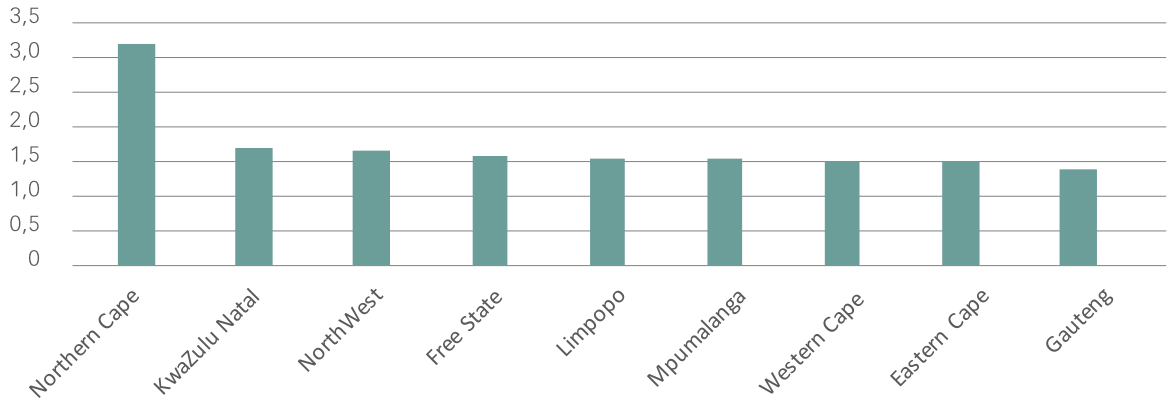
Figure 71 provides the results for 2010. The Northern Cape had the highest fiscal effort (1.4102), followed by KwaZulu-Natal (1.3477), North West (1.3459) and Free State (1.3402). The three provinces with the lowest fiscal effort were Gauteng, Eastern Cape and Western Cape with indexes of 1.1738, 1.2640 and 1.2866 respectively.

Figure 71. Overall index for fiscal effort (2010)



Source: Author's calculations

Figure 72. Overall index for fiscal effort (2014)



Source: Author's calculations

Figure 72 presents the results for 2014. The Eastern Cape had the highest fiscal effort with an index of 2.9244, followed by Northern Cape (1.5393), North West (1.4923) and Limpopo (1.4392). Gauteng, Western Cape and Free State had the lowest fiscal effort, with indexes of 1.2508, 1.3612 and 1.3767 respectively.

The main objective of this quantitative analysis was to establish the extent to which provinces are maximising their own-revenue collection from current sources, by calculating the tax effort using the RTS approach. The results revealed that provinces have very different levels of tax effort. Generally, the North West and Eastern Cape have the highest and the Western Cape and Gauteng have the lowest level of tax effort. The results also show that the effort exerted in collecting own-tax revenue is greater in rural provinces than in urban provinces. This can be explained by the composition of own-tax revenue: the amount of tax collected is largely a function of the concentration of economic activity. The noticeable discrepancies in fiscal effort among rural and urban provinces also imply different tax bases. Across all provinces, the tax effort increased drastically between 2005 and 2014. The differences between potential and actual tax revenues suggest that provinces are relatively optimising their collection of own revenues and in some instances "overtaxing" their tax bases.

7.5 Conclusions and Recommendations

7.5.1 Conclusions

The fiscal decentralisation and IGFR systems entrenched by the Constitution assign provinces narrow-based taxes, which means that they have low fiscal autonomy and tax-raising powers. This constitutional constraint means that all provinces – and especially rural provinces – have a limited ability to generate own revenues.

Provinces in South Africa levy only a few of the taxes identified in the literature as appropriate sources of own revenues for subnational governments, including automotive and fuel taxation, surcharges on a nationally uniform PIT, a provincial VAT and business value tax. This is in line with the Financial and Fiscal Commission's Framework Document for Intergovernmental Fiscal Relations (FFC, 1995) which recommended personal income tax, excise duty and fuel levies as provincial taxes for South Africa.

Urban provinces generate more own revenues than rural provinces. Rural provinces' own revenues have grown at a higher annual rate than urban provinces, albeit from a very low base. With the exception of KwaZulu-Natal, rural provinces have low own revenues and high levels of poverty – poverty also contrains the ability of rural provinces to generate own revenues. Urban provinces generate more own revenues across all major sources, i.e. motor vehicle licensing taxes, casino taxes and horse racing taxes. Motor vehicle licensing is the most important source of own revenues for provinces. These main sources of own revenues for provinces are primarily price-elastic goods and services that make the tax bases sensitive to price increases, especially in rural areas.

Conditional grants to provinces have consistently grown faster than own revenues, which implies a lack of fiscal effort by provinces to generate own revenues. The analysis found that the North West and the Eastern Cape have the highest and the Western Cape and Gauteng have the lowest levels of tax effort, suggesting that rural provinces exert more effort than urban provinces in the collecting own tax revenue. Some provinces were found to be relatively optimising their collection of own revenues to such an extent that in some instances they are "overtaxing" their tax bases.

7.5.2 Recommendations

South Africa's constitutional arrangements have deliberately centralised the collection of revenue at national level. Provinces collect a very small fraction in own revenues. The urban provinces collect more own revenues because they contain economic activities, which also means broader tax bases. Rural provinces collect less own revenues because their tax bases are narrow, and the fiscal effort is relatively optimal across all provinces. The following is recommended:

- Enhanced inclusive economic growth and employment in order to grow tax bases for rural provinces, and thereby mobilise more resources for rural development at provincial level.

- Investment in enabling infrastructure that will boost exports through de-monopolising and increasing competition in the energy, transport and telecommunication sectors, thereby enhancing growth and employment.

- Investment in quality education and training to address skills mismatches between the education system and the labour market, thereby reducing unemployment and boosting growth.

7.6 References

Ajam, T. 2006. Fiscal federalism. In Black, PA, Calitz, E, Steenekamp, TJ and associates. 2011. Public Economics 5th Edition. Cape Town: Oxford University Press.

Bahl, RW. 1972 A regression approach to tax effort and tax ratio analysis. Staff Papers IMF

Bahl, RW and Linn, JF. 1992 Urban Public Finance in Developing Countries. New York: Oxford University Press.

Bird, R and Zolt, E. 2005. Redistribution via taxation: the limited role of the personal income tax in developing countries. UCLA Law Review, 52(6): 1627–95.

Bird, R, Mintz, J and Wilson, T. 2006. Coordinating federal and provincial sales taxes: lessons from the Canadian experience. National Tax Journal, 49(4): 889–903.

FFC (Financial and Fiscal Commission). 1995. Framework Document for Intergovernmental Fiscal Relations in South Africa. http://www.ffc.co.za/index.php/docman-menu-item/ffc-general/635-framework-document-for-igfr-in-sa/file

Gwanya, T. 2010. South Africa position paper on rural development: a model for the comprehensive rural development programme. Paper presented at the International Conference on Dynamics of Rural Transformation in Emerging Economies, 14-16 April 2010, New Delhi, India.

Keen, M and Lockwood, B. 2006. Is the VAT a money machine? National Tax Journal, 49 (4): 905–28.

Khumalo, B and Rao, G. 2004. Sharing the cake: a review of provincial equitable share formula in South Africa. Paper presented at the conference Celebrating Ten Years of the Financial and Fiscal Commission: Consolidation for Greater Equity, 10–12 August 2004, Cape Town, South Africa.

Kole, NM. 2005. An Evaluation of the Integrated Sustainable Rural Development Programme Highlighting Stakeholder Mobilisation and Engagement. Unpublished BSc dissertation, University of Pretoria.

May, J. 2000. Poverty and Inequality in South Africa: Meeting the Challenge. Cape Town and London: David Philip Publishers and Zen Press.

McLure, C. 1994. The tax assignment problem: ends, means, and constraints, Australian Tax Forum, 11: 153–83.

Smith, R. 1991. Motor vehicle taxation. In Bahl, R (ed.). The Jamaican Tax Reform. Cambridge, MA: Lincoln Institute of Land Policy.

Söderström, L. 1991. Fiscal federalism: the Nordic countries' style. In Prud'homme, R (ed.). Public Finance with Several Levels of Government. The Hague/Koenigstein: Foundation Journal Public Finance.

Stiglitz, JE. 1999. Taxation, public policy and the dynamics of employment. International Tax and Public Finance, 6: 239–262.

Tait, A. and Eichengreen, J. 1978. Two Alternative Approaches to International Comparisons of Taxation. Washington, DC: (IMF Departmental Memorandum 78/73).

Tanzi, V. 1981. A Statistical Evaluation of Taxation in Sub-Saharan Africa. Washington, DC: IMF. 45–50.

World Bank. 2007. Designing a Tax System for Micro and Small Businesses: Guide for Practitioners. Washington, DC: World Bank.

Appendix: Selected Provincial Tax Revenue Sources and Tax Bases

Tax Revenue	Tax Bases
Liquor licences	Retail trade in beverages
Motor vehicle licences	Maintenance of motor vehicles
Casino taxes	Hotels, camping sites and other accommodation
Horse racing taxes	Recreational, cultural and sporting activities

Statistical Appendix

Table 43. Tax revenue receipts by province

Province	Year	Revenue Sources			Total
		Motor vehicle licences	Casino taxes	Horse racing taxes	
Western Cape	2005/06	0.758594	0.205318	0.01665	0.984864
	2010/11	0.901651	0.296313	0.02633	1.230722
	2014/15	1.143991	0.299335	0.02	1.488326
Eastern Cape	2005/06	0.303589	0.055733	0.00262	0.367907
	2010/11	0.331964	0.085533	0.00656	0.428859
	2014/15	0.459368	0.124631	0.00661	0.599217
Northern Cape	2005/06	0.059068	0.011798	0.00039	0.072131
	2010/11	0.115246	0.013706	0.00062	0.130638
	2014/15	0.146842	0.017597	0.00147	0.169564
Free State	2005/06	0.179036	0.011243	0.00509	0.197789
	2010/11	0.300907	0.025739	0.00543	0.337697
	2014/15	0.486598	0.036864	0.00906	0.539209
KwaZulu-Natal	2005/06	0.624302	0.162073	0.03198	0.822356
	2010/11	1.083507	0.305583	0.04586	1.43997
	2014/15	1.452633	0.457046	0.07456	2.00585
North West	2005/06	0.143205	0.050787	0.00276	0.196754
	2010/11	0.198624	0.060638	0.00419	0.265763
	2014/15	0.372149	0.100679	0.00582	0.482399
Gauteng	2005/06	0.959577	0.388748	0.02597	1.374291
	2010/11	1.705814	0.58598	0.03066	2.32245
	2014/15	1.705814	0.58598	0.03066	2.32245
Mpumalanga	2005/06	0.149918	0.022444	0.0035	0.177206
	2010/11	0.238951	0.043961	0.00426	0.289534
	2014/15	0.371302	0.072006	0.00794	0.453462
Limpopo	2005/06	0.127946	0.00824	0.0033	0.143786
	2010/11	0.194721	0.02093	0.00866	0.227015
	2014/15	0.307034	0.050807	0.01056	0.37196
Totals	2005/2006	3.305235	0.916384	0.09227	4.337084
	2010/2011	5.071385	1.438383	0.13256	6.672648
	2014/2015	6.445731	1.744945	0.16668	8.432437

Table 44. Selected provincial tax bases

Province	Year	Tax Base			Total
		Maintenance of motor vehicles	Hotels, camping sites and other accommodation	Recreational, cultural and sporting activities	
Western Cape	2005	0.153362	0.11255	0.029168	0.295083
	2010	0.3554688	0.3089	0.219472	0.883844
	2014	0.4938523	0.28672	0.3631	1.143668
Eastern Cape	2005	0.0930466	0.06059	0.043352	0.19699
	2010	0.3591844	0.33191	0.197984	0.889074
	2014	0.5020227	0.46028	0.235157	1.19746
Northern Cape	2005	0.1112318	0.06941	0.055011	0.23565
	2010	0.3083105	0.27321	0.265534	0.847057
	2014	0.395668	0.31563	0.399402	1.110704
Free State	2005	0.0724514	0.02691	0.031897	0.131258
	2010	0.2915509	0.23983	0.202614	0.733999
	2014	0.4642232	0.37465	0.322241	1.161111
KwaZulu-Natal	2005	0.0731063	0.03597	0.046181	0.155255
	2010	0.357142	0.21223	0.296676	0.866047
	2014	0.5079958	0.226	0.434399	1.168394
North West	2005	0.1171575	0.05527	0.034665	0.207094
	2010	0.3215043	0.25949	0.238789	0.819786
	2014	0.45842	0.42482	0.418452	1.30169
Gauteng	2005	0.104805	0.03739	0.033669	0.175867
	2010	0.431708	0.22426	0.228983	0.884956
	2014	0.5835273	0.24194	0.3514	1.17687
Mpumalanga	2005	0.0934467	0.04259	0.03381	0.169846
	2010	0.3727338	0.33771	0.232232	0.942674
	2014	0.4844507	0.41808	0.373195	1.275727
Limpopo	2005	0.1071854	0.06348	0.046633	0.2173
	2010	0.3863577	0.33955	0.270145	0.99605
	2014	0.4994547	0.451	0.408182	1.358639
Totals	2005	0.9257927	0.50416	0.354386	1.784342
	2010	3.1839604	2.5271	2.152428	7.863486
	2014	4.3896147	3.19912	3.305528	10.89426

Table 45. National average tax rates

Revenue Source	2005	2010	2014	2005	2010	2014
Motor Vehicle	3.57	1.59279	1.4684047	0.0357	0.015928	0.014684
Casino Taxes	1.818	0.56918	0.5454453	0.01818	0.005692	0.005454
Horse Racing	0.26	0.06159	0.0504234	0.0026	0.000616	0.000504

Table 46. Potential tax revenues (R-billions)

Province	Year	Source of Revenue			Total
		Motor vehicle licences	Casino taxes	Horse racing taxes	
Western Cape	2005	0.54753	0.20458	0.00759	0.759702
	2010	0.56619	0.1758227	0.01352	0.755527
	2014	0.72517	0.1563877	0.01831	0.899871
Eastern Cape	2005	0.33219	0.1101342	0.01129	0.453613
	2010	0.57211	0.1889152	0.01219	0.773214
	2014	0.36405	0.0719822	0.00431	0.440342
Northern Cape	2005	0.39712	0.1261559	0.01432	0.537595
	2010	0.49107	0.1555082	0.01635	0.662936
	2014	0.581	0.1721611	0.02014	0.773301
Free State	2005	0.25866	0.048913	0.0083	0.315881
	2010	0.46438	0.13651	0.01248	0.613368
	2014	0.68167	0.204349	0.01625	0.902265
KwaZulu-Natal	2005	0.261	0.0653751	0.01202	0.3384
	2010	0.56885	0.1207973	0.01827	0.707921
	2014	0.74594	0.1232702	0.0219	0.891118
North West	2005	3.57017	1.8176327	0.26035	5.648155
	2010	0.51209	0.1476987	0.01471	0.674494
	2014	0.67315	0.2317149	0.0211	0.925961
Gauteng	2005	0.37417	0.0679657	0.00877	0.450903
	2010	0.68762	0.1276479	0.0141	0.829371
	2014	0.85685	0.1319665	0.01772	1.00654
Mpumalanga	2005	0.33362	0.0774107	0.0088	0.419834
	2010	0.59369	0.1922177	0.0143	0.800207
	2014	0.71137	0.2280406	0.01882	0.958228
Limpopo	2005	0.38267	0.115386	0.01214	0.510197
	2010	0.61539	0.1932653	0.01664	0.82529
	2014	0.7334	0.2459971	0.02058	0.999981
Totals	2005	3.30524	0.916384	0.09227	4.313885
	2010	5.07139	1.438383	0.13256	6.642329
	2014	6.44573	1.744945	0.16668	8.357352

Table 47. Index for fiscal effort

Province	Year	Source of Revenue			Total
		Motor vehicle licences	Casino taxes	Horse racing taxes	
Western Cape	2005	0.28	0.55017	3.8409179	0.38842
	2010	0.628	1.7569	16.237263	1.16984
	2014	0.681	1.83336	19.832057	1.27092
Eastern Cape	2005	0.28	0.55017	3.8409179	0.43427
	2010	0.628	1.7569	16.237263	1.14984
	2014	1.379	6.39436	54.61877	2.71939
Northern Cape	2005	0.28	0.55017	3.8409179	0.43834
	2010	0.628	1.7569	16.237263	1.27774
	2014	0.681	1.83336	19.832057	1.43631
Free State	2005	0.28	0.55017	3.8409179	0.41553
	2010	0.628	1.7569	16.237263	1.19667
	2014	0.681	1.83336	19.832057	1.28688
KwaZulu-Natal	2005	0.28	0.55017	3.8409179	0.45879
	2010	0.628	1.7569	16.237263	1.22337
	2014	0.681	1.83336	19.832057	1.31116
North West	2005	0.033	0.03041	0.1331438	0.03667
	2010	0.628	1.7569	16.237263	1.21541
	2014	0.681	1.83336	19.832057	1.40577
Gauteng	2005	0.28	0.55017	3.8409179	0.39003
	2010	0.628	1.7569	16.237263	1.06702
	2014	0.681	1.83336	19.832057	1.16922
Mpumalanga	2005	0.28	0.55017	3.8409179	0.40455
	2010	0.628	1.7569	16.237263	1.17804
	2014	0.681	1.83336	19.832057	1.33134
Limpopo	2005	0.28	0.55017	3.8409179	0.42591
	2010	0.628	1.7569	16.237263	1.20691
	2014	0.681	1.83336	19.832057	1.35867
Totals	2005	0.28	0.55017	3.8409179	0.41363
	2010	0.628	1.7569	16.237263	1.18384
	2014	0.681	1.83336	19.832057	1.30355

Table 48. Overall fiscal effort by province

Province	Year	Total
Western Cape	2005	0.509
	2010	1.287
	2014	1.361
Eastern Cape	2005	0.635
	2010	1.264
	2014	2.924
Northern Cape	2005	0.608
	2010	1.41
	2014	1.539
Free State	2005	0.703
	2010	1.34
	2014	1.377
KwaZulu-Natal	2005	0.727
	2010	1.348
	2014	1.402
North West	2005	0.053
	2010	1.346
	2014	1.492
Gauteng	2005	0.592
	2010	1.174
	2014	1.251
Mpumalanga	2005	0.621
	2010	1.288
	2014	1.416
Limpopo	2005	0.604
	2010	1.314
	2014	1.439
Totals	2005	0.603
	2010	1.303
	2014	1.391