



# Submission on the Application from eThekweni Metropolitan Municipality for the Authorisation of a Local Business Tax

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IN TERMS OF SECTION 5 OF THE MUNICIPAL FISCAL  
POWERS AND FUNCTIONS ACT, 2007 (ACT NO. 12 OF  
2007)

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Financial and Fiscal Commission  
Montrose Place (2<sup>nd</sup> Floor), Bekker Street,  
Waterfall Park, Vorna Valley, Midrand,  
Private Bag X69, Halfway House 1685

[www.ffc.co.za](http://www.ffc.co.za)

Tel: +27 11 207 2332

Fax: +27 388 3965

*For an Equitable Sharing of National Revenue*

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## 1. Background

On 13 December 2011, the Financial and Fiscal Commission (FFC) received a request from the Minister of Finance to advise him on an application received from ETHEKWINI METROPOLITAN MUNICIPALITY. The application set out the municipality's request for the Minister to approve the introduction of a local business tax (LBT) in terms of Section 5 of the Municipal Fiscal Powers and Functions Act (MFPFA) 2007 (Act No. 12 of 2007). This consultation process initiated by the Minister of Finance is a pre-requisite of the MFPFA prior to him authorising a municipal tax.

The application from ETHEKWINI METROPOLITAN MUNICIPALITY presents 3 parts that require a response:

- (a) Application for a new **local business tax for economic infrastructure and services** to be introduced for South Africa's metropolitan governments, the proceeds of which are to be used exclusively for economic infrastructure and services;
- (b) Recommendation that the share of the fuel levy currently accruing to metropolitan governments is dedicated to funding transport infrastructure and operations, including public transport; and
- (c) Recommendation that legislation should be introduced to implement the new tax, and that it specify accompanying governance mechanisms aimed at enhancing accountability and transparency, and ensuring that the revenue is used for the purposes for which it is designed.

Based on the analysis that will be reported on in the rest of this document, the Commission makes two main recommendations to the Minister of Finance on the proposal as follows:

- (a) The Minister should in principle *approve* the proposal for a new local business tax to be introduced for South Africa's metropolitan governments. It is the Commission's view that in terms of the legal requirements, the application is procedurally compliant. Although likely to be inequitable at the margin amongst households, business, municipalities and regions, the low uniform rates with universal coverage proposed ensure that local business taxes provide one of the few ways in which local governments in South Africa can have some measure of much desired fiscal discretion to address developmental needs that constituents have bought into.
- (b) The local business tax approval should be accompanied by built-in performance incentive systems designed to be mutually strengthening and have a significant impact on the basic conditions for local government service delivery. In other words, the approval must be structured to ensure that all municipalities can access the revenue source, provided that they have shown signs of commitment. For quality control

purposes, a graduated approval system based on the following milestones should be used:

- a. Demonstrate municipal stability and viability
- b. Enter into an incentive agreement with local business that specifies performance milestones
- c. Demonstrate yardstick competition with other municipalities
- d. A cost-benefit analysis will be conducted for each applicant for incentives. The incentive amount is determined by the city/municipality tax cash flow over a seven-year period. The community return on investment time period projected by the cost-benefit analysis will, in all cases, not exceed seven years.
- e. Three years of unqualified or clean audits (financial statements) are required for credit worthiness analysis.

Once all metros achieve the targets the tax should be non- discretionary.

The Commission's submission is has six sections. Following the introduction, Section 2 discusses issues pertaining to usage of the funds, discussing earmarking of proceeds from the tax and briefly mentioning the merits of respective arguments. Section 3 discusses the relative rate of return of the LBT in the context of economic transformation towards a knowledge based economy. Section 4 briefly discusses the LBT enabling legislation and then sets out criteria that can be used to assess the major (economic) issues raised by LBTs at the local level. Based on those criteria, it then considers the suitability of LBTs as a source of finance for local government – i.e. what its impact would be on the level and distribution of local government financial resources and how it would influence the accountability of local government decision making. Here the key issues are related to the practical aspects evaluated and economic questions raised. Section 5 assesses other financial and economic considerations such as fiscal space, fiscal gap and fiscal sustainability surrounding the application. Conclusions are summarised in Section 6 and a recommendation given.

## **2. Usage of local business tax proceeds**

The extent to which local discretion should be given to municipalities over the usage of the local business tax proceeds and the extent to which these funds should be earmarked for expenditures determined by the centre is an important consideration. Invariably, national departments will apply some parameters for local discretion in some areas to ensure adherence to national targets. Beyond this there are many points on a spectrum whose end point is defined by very highly specified usages (such as an area where the funds may only be spent on, say, road construction). However, there is a trade off, as tight control and earmarking of funds will constrain the space for the emergence of efficiency in resource allocation based on local priorities achieving the overall objectives of devolution. Systems with more autonomy in resource utilization will typically be supported by stronger incentive systems/performance measures.

### 3. Relative rate of return from implementation of a local business tax for metropolitan municipalities

The application of a local business tax for metropolitan municipalities cannot create additional value where it is intended to fund recurring infrastructure costs. However, the application of a local business tax for metropolitan municipalities may create additional value where its purpose is to fund infrastructure that provides opportunities for new economic or social development.

South Africa's metropolitan municipalities are negatively affected by the long term economic slowdown. While the City of Johannesburg's and Tshwane metro's revenues may grow significantly in the next decade, due to the ever-increasing concentration of business in these cities, the revenue prospects for Ekurhuleni metro, for example, may be reduced in future years due to the long term decline of industry in this area, while the revenues for Nelson Mandela, Cape Town and eThekweni metros are likely to remain static. In other words, the tax base of only two metros is likely to increase, while the tax base of three others is likely to remain unchanged and the tax base of at least one metro is likely to decline. Any tax raised at local level should have specific value creation objectives, either social or economic.

Metropolitan municipalities are important entities for shifting the economic focus of South Africa from a historically manufacturing and services-based economy to a medium-knowledge-intensive economy. Little more economic value can be gained from growing the manufacturing sector, given a global glut of manufactured products. There is, however, room for growth through improving the quality and capability of the manufactured goods that South Africa does produce, as well as improvement in the quality and value of services in the broad services sector including government. Such a growth trajectory will require a shift to a knowledge-based economy, where knowledge is an input to create additional value. The metropolitan municipalities operate the provision of aging industrial-era infrastructure. This is not an adequate basis for the introduction of new economic sectors or raising the capabilities of existing economic sectors. Hence, a local business tax which merely aims to replace aging infrastructure is not a long term solution for economic development.

On the other hand, localised investment in creating the conditions for long term economic development would be a worthwhile endeavour if aimed at fuelling new economic sectors or significantly upgrading existing sectors. An example of a new economic sector would be establishing a globally-competitive nutraceutical industry (as considered in the Ten Year Innovation Plan 2018) capable of competing with the small emerging nutraceutical industries in the US and Germany. An example of an existing sector would be the automotive manufacturing sector, which is not keeping pace with the shift to knowledge-intensive production in automotive manufacturing across the world. Furthermore, investment in social infrastructure for knowledge-intensive production, such as supporting infrastructure to schools and the conversion of under-utilised community centres to small proto-economic hubs can have long term benefits to the local and national economy.

Hence, if a local business tax for metropolitan municipalities is to be considered, the decision should be based partly on an understanding of the relative rate of return from spending R1 to replace aging infrastructure as compared to spending R1 to create infrastructure for new economic production. It is argued that the replacement of aging infrastructure should be funded through efficiency gains and the reduction of corruption and wastage in existing budgets. Any future local business tax may be justified where applied to infrastructure that will attract long term new investment in economic sectors that will improve South Africa's global positioning and increase its global competitiveness.

#### **4. Assessment: Suitability of a local business tax as a source of local financing**

The ETHEKWINI METROPOLITAN MUNICIPALITY proposal document addresses extremely well all the requirements set out in Section 5(1) of the MFPPA, which reads as follows:

5. (1) A municipality, group of municipalities or organised local government must submit an application to the Minister, which application must—
- (a) set out the reasons for the imposition of the proposed municipal tax;
  - (b) the purposes for which revenue derived from the collection of the municipal tax will be utilised;
  - (c) give particulars on the proposed municipal tax's compliance with section 229(2)(a) of the Constitution;
  - (d) give particulars on the proposed municipal tax's compliance with the prohibition contained in section 229(1) (b) of the Constitution;
  - (e) identify and, where appropriate, describe—
    - (i) the tax base;
    - (ii) the desired tax rate;
    - (iii) the persons liable for the tax; and
    - (iv) any tax relief measures or exemptions;
  - (f) specify—
    - (i) the tax-collecting authority;
    - (ii) the persons responsible for remitting the tax;
    - (iii) the methods and likely costs of enforcing compliance with that tax;
    - (iv) the compliance burden on taxpayers; and
    - (v) procedures for taxpayer assistance;
  - (g) give particulars of, and describe the estimation methods and assumptions used to determine—
    - (i) the amount of revenue to be collected on an annual basis over the three municipal financial years following the introduction of the municipal tax;
    - (ii) the economic impact on individuals and businesses; and
    - (iii) the impact on economic development;
  - (h) give particulars of any consultations conducted, including consultations with, where applicable, provincial government, organised local government and municipalities, and the outcomes of such consultations;
  - (i) give particulars of any consultations with the South African Revenue Service and any other collecting agent contemplated in section 7, regarding the administration of the proposed municipal tax; and
  - (j) include such other information as may be prescribed.

What is important to note here is that in line with economic arguments made against earmarking above, nowhere in the MFPFA does it say that authorisation of a municipal tax ought to be based on the manner in which revenue earned will be used. Hence this is not a requirement within the current legislation. As pointed out in the application document, however, although the proposal has been compiled in terms of the MFPFA and the proposed tax complies with the conditions imposed by this Act and by section 229 of the Constitution, the way the tax is proposed to be legislated and administered results in it being defined in technical legal terms as a national tax. It therefore satisfies section 229 of the Constitution.

Furthermore, there is international precedence to business taxation, for example in places such as United States of America, Canada, Germany, Italy (on which the proposal is modelled), Hungary, other European Union countries, Japan, India, Brazil, other Latin American countries, Kenya as well as Francophone Africa. Business taxation in these different countries takes diverse forms, however, with some places relying on taxes on profits and property; some on various forms of sales taxation; some on a variety of specific charges and fees. Given such diversity, the ultimate question to address is what the impact would be of assigning the LBT to municipalities on the budgeting position and functioning of municipalities as well as the wider economy (Myles, 1995). To help in addressing this question, use (albeit with minor modifications) is made of the principles that should underpin a good local tax identified by FFC as part of its 2009/10 Division of Revenue Annual submission:

- a. *Revenue Adequacy*: The amount of revenue gained from the tax should mirror the expenditure responsibility assigned;
- b. *Correspondence*: The burden of the tax should not overlap to adjacent municipalities whose citizens do not benefit from the expenditure of the tax funds;
- c. *Effective Administration*: The cost of administering the tax should be reasonably fair;
- d. *Enhances Local Fiscal Autonomy*: the base, rate and administration of the tax should have a strong local element i.e. should be controlled by the municipality;
- e. *Yield*: The tax should contribute significantly to the municipality's revenue;
- f. *Collectability*: Related to point c, the tax should be easily collectible at a low cost;
- g. *Economic Efficiency*: Local taxes should not promote economic inefficiencies whereby taxpayers adjust their economic decisions away from the most optimal towards areas where taxation is minimised;
- h. *Immobility of Base*: A local tax should be based upon assets or activities that are not easily transferrable or movable to another municipal jurisdiction. This would ensure that the economic efficiency principle is also maintained where the activity remains at its economically optimal location as opposed to moving to a less optimal location in order to minimise tax;
- i. *Base Stability in Economic Cycles*: Revenues from a local tax should be buoyant at times of economic growth and less vulnerable to negative turns in the economy
- j. *Horizontal Fiscal Imbalance*: A local tax within a municipality should not promote horizontal fiscal imbalances where significantly large disparities are created between municipalities;

- k. *Fairness*: The local tax should ensure that the burden is equitably shared, vertically and horizontally, among the taxpayers (be it households, companies etc);
- l. *Transparency*: All aspects of the tax, including the purpose, legal basis, revenue, expenditure, base and rate of the tax, should be clear and liable to public scrutiny at any time; and
- m. *Accountability*: Similar to point a, the tax authority should be accountable on how much is collected from the local tax and how much and the areas where the revenues from the tax are being spent.

Table 1 gives an assessment of the eThekweni proposals against some of these criteria.

**Table 1: Evaluation of Local Business Tax Proposal by eThekweni**

<b>Criterion</b>	<b>Assessment</b>
<b>Revenue adequacy</b>	Yes at metro and regional level
<b>Revenue buoyancy</b>	Yes
<b>Correspondence of payers and beneficiaries</b>	Potentially satisfactory
<b>Progressivity</b>	No
<b>Administrative cost</b>	Not high, feasible
<b>Compliance cost</b>	Probably moderate, not any higher than VAT
<b>Political acceptability</b>	Unknown until after unions have been consulted
<b>Local accountability</b>	Probably high if done without extra national conditions on earmarking and accountability
<b>Reduces regional disparity</b>	No

Although the judgments in Table 1 are obviously essentially subjective, it is difficult to avoid the conclusion that the local business tax proposal does not appear to score well on many of those criteria. The proposal is inequitable (see Annexure 7 and 8 of the ETHEKWINI METROPOLITAN MUNICIPALITY proposal). Even after adjustments, no case has been made that they will be neutral. The LBT would have uneven (initial) impact on the financial resources available to different local authorities, reflecting the uneven distribution of business. Metros with large clusters of business would generally derive considerably more additional revenue than would most suburban or rural authorities. Thus, even within metros, the proposal accentuates rather than reduces disparities between localities, giving most to those who have most. Our assessment is that the proposal will likely be acceptable politically, in part because no one quite knows who really pays business taxes but many people think someone else pays (Bird, 2002). In other words, resistance is likely to be mitigated by the uncertain ultimate incidence of the proposed tax. Furthermore, the very low rates proposed make the proposal relatively attractive to business. Labour unions would need, however, to be brought on board early on as the findings suggest that the proposal in net terms will harm employment. The list of groups consulted by ETHEKWINI METROPOLITAN MUNICIPALITY does not include organised labour and this can constitute a problem when it comes to implementing the tax.

Our assessment is that LBTs provides an important, and relatively elastic, source of revenue, particularly for larger cities. The LBT, defective as it may be in design and execution, provides one of the few ways in which local governments have any degree of fiscal discretion. Universal coverage of the tax at a uniform rate minimises violation of the “correspondence principle” that those who pay should be those who benefit. Finally, at a 2 percent of the yield likely to be charged by SARS (South African Revenue Services), the proposal does not appear that costly to administer, especially if one takes into account, as one should, the cost of compliance and the facility with which the tax can serve as the basis for corrupt transactions.

The question is therefore to what extent the virtues of local business taxation — essentially money and discretion — can be realized while minimizing such vices as economic distortions, inequity and unemployment. The Commission’s view is that the low rates proposed lessen those problems. While the local business tax will have negative impacts on the economy in the short run, the impact is likely to be close to zero or more precisely - 0.0036%. The small negative impact can be reversed if there is a positive productivity gain from use of the tax proceeds. Theory, empirical evidence, and common sense thus all suggest that it makes economic sense in most circumstances to keep local taxes on business as low as possible and this is done by restricting the application to a meagre 0.323% of business turnover. Concerning the point that the tax on business will give more revenues to those who have more tax base and discriminates to the extent that it applies only to Metros only and hence will accentuate fiscal disparities between localities, it’s important to note that strictly speaking the tax applies to all localities and hence this point need not be used to block the tax. However, for reasons of administrative simplicity and also to avoid perverse ‘border effects’, the proposed tax is collected from the whole country rather than in the defined municipalities only. There would be a ‘Rest of South Africa’ (everything except the Metros) component of the tax receipts. Any tax on business will give more revenues to those who have more tax base and this is the intention (user pay principle). It therefore will accentuate fiscal disparities between localities but the point is in essence based on the benefit principle. Finally, as mentioned earlier, while this application amounts to a national tax and hence evaluating it under Section 5 of the Municipal Fiscal Powers and Functions Act may seem inappropriate, we think this in principle is simple to overcome. In the main the Minister has asked the Commission to evaluate the tax against Section 5 of the Municipal Fiscal Powers and Functions Act. More fundamentally, for the correspondence principle, all that is needed to overcome the problem is to introduce clear political responsibility at the local level for the taxes imposed. Even when taxes are collected by central governments, on bases determined by those governments, political accountability can be achieved as long as the subnational government that receives and spends the revenues is clearly responsible to its citizens for the revenues and eventually rates.

## 5. Other considerations: Fiscal space, gap and sustainability

The following points from the ETHEKWINI METROPOLITAN MUNICIPALITY proposal need to be flagged:

- Unpacking more the (tax) principles: Economics of the argument for LBT may not be sound because incidences of the taxes are not fully understood and other distortions (capital and skills flight for instance) are not taken into account. Such issues, however, will only become important should rates begin to rise beyond certain acceptable levels in the future and the Minister of Finance is requested to approve a rate hike.
- The argument made in the proposal that tax room exists is contestable and needs thorough analysis. The question here that the FFC is alluding to is whether indeed there is *fiscal space*?
  - Fiscal space is defined as availability of budgetary room that allows (local) government to provide resources for infrastructure and services without any prejudice to the sustainability of overall government's financial position.
  - Issue of fiscal space cannot be restricted to one particular sector, tax or sphere as for example, resources available to local government depend on government's overall fiscal policies, demands of competing sectors to infrastructure and spillover effects from one sector to another. In short it is a set of political decisions on allocation of public resources between competing priorities.
  - The Minister of Finance may wish to give guidance on what level of overall tax burden is desirable for South Africa in this regard.
- Related to the issue of fiscal space, the proposal also raises the issue of *Fiscal Sustainability*
  - Fiscal sustainability refers to the ability of government to sustain spending on a desired purpose for its planned duration and meet borrowing costs without compromising government's financial position – i.e. government must be able to cover the recurrent costs of any new capital investment as well as cost of capital (opex and capex) raised by the proposal to finance local infrastructure through LBT.
- Metro governments potentially face a significant fiscal gap between their expenditure responsibilities and revenue resources. Detailed studies of the infrastructure needs of ETHEKWINI METROPOLITAN MUNICIPALITY suggest that the city has capital expenditure requirements of R85.3 billion (R62.7 billion in 2010 values) over the next decade. This capital expenditure requirement of course comes with substantial new operational demands. This Local Business Tax should not be viewed as the sole solution to the fiscal gap but as a part to the solution. The structural fiscal gap cannot

be closed without simultaneously taking measures to close the efficiency gap. Some examples of the means that could be used to close the fiscal gap include: (i) more revenue performance incentives, particularly on underused but efficient instruments for infrastructure finance, such as Development Charges (which better match cost and benefit incidence); (ii) expenditure oversight, etc.

- *Policy Coherence*: There is a need to pay more attention to the link between the proposal and developments elsewhere such as the National Health Insurance (NHI), proposed mandatory social security reform as well as the Road Accident Fund (RAF), mining as well as carbon tax. Cumulatively, these major reforms create an administrative overhead for business. If one adds to this the mandatory retirement saving deductions and likely deceleration in wage increases as business finds it increasingly hard to award wage increases, the burden becomes huge. This regime will create pressures on employers to increase salaries, at least partially to offset this. So wage pressures are very likely. So what is going to be the wage inflation impact of the combined tax proposals? There are these economic and social risks associated with the proposal – and Minister of Finance in particular – ought to carefully weigh.

## **6. Recommendations for Minister of Finance on the local business tax proposal**

In this submission the Commission has considered whether a local business tax could play a useful role in South African system of local government finance. The context in which the proposal has been considered is one in which the local business tax might be introduced to supplement existing local revenues, rather than as a replacement for the abolished RSC/JSB levies. A local business tax is likely to be one of the ways in which local government could be given tax revenue sources sufficient to cover a larger proportion of spending than at present, reducing the problems that arise due to higher gearing of spending changes into local government tax changes under the present system. Distributional considerations are probably the main obstacle to a local business tax. The tax would bear particularly heavily on poorer households, reflecting the importance of unskilled unemployment in poorer households' incomes. Irrespective of how well-designed, any tax on business will give more revenues to those who have more tax base. It therefore will accentuate fiscal disparities between regions and localities.

It is the Commission's view that the Minister of Finance ought to carefully weigh the impact of increasing fiscal space and using resources in local government against the risk associated with increasing taxation rates, increasing expenditure levels, re-allocating expenditure from other spheres, etc. Although local business taxes are likely to be regressive at the margin, the equity of local taxation is a much less important issue because municipalities can be considered to be entities that provide services to residents so that the appropriate equity perspective is the benefit principle, rather than the ability-to-pay principle. Even from the latter perspective, the equity issue may be approached at two different levels. First, one can consider the details of the relative treatment, in law and in practice, of the tax burdens

imposed on taxpayers in the same and different economic circumstances. Secondly, one may instead focus on the overall taxation effects on people's income and level of well-being. Focusing on the implications for equity of details of particular taxes tends to result in proposals to alter the rates and structures of particular taxes. Those proposals, while they may improve horizontal and vertical equity within the limited group, who are actually subject to the full legal burden of the tax in question, may at the same time actually exacerbate inequity more broadly considered. From the perspective of social and economic inequality, what matters in the end is the overall impact of the budgetary system on the distribution of wealth and income. The precise incidence of specific local government taxes seldom has much importance in that context, and it would be a mistake to complicate the system excessively in terms of economic, administrative, and compliance costs in an attempt to achieve miniscule, if any, gains in equity terms.

Based on analysis reported in this document, Financial and Fiscal Commission recommends that:

- (a) The Minister should in principle *approve* the proposal for a new local business tax to be introduced for South Africa's metropolitan governments. The application is technically compliant, so there is no basis for a procedural rejection. Although likely to be inequitable at the margin amongst households, business, municipalities and regions, the low uniform rates with universal coverage proposed ensure that local business taxes provide one of the few ways in which local governments in South Africa will have some measure of much desired fiscal discretion to address developmental needs that constituents have bought into.
- (b) The local business tax approval should be accompanied by built-in performance incentive systems designed to be mutually strengthening and have a significant impact on the basic conditions for local government service delivery. In other words, the approval must be structured to ensure that all municipalities can access the revenue source, provided that they have shown signs of commitment. For quality control purposes, a graduated approval system based on the following milestones should be used:
  - a. Demonstrate municipal stability and viability
  - b. Enter into an incentive agreement with local business that specifies performance milestones
  - c. Demonstrate yardstick competition with other municipalities
  - d. A cost-benefit analysis will be conducted for each applicant for incentives. The incentive amount is determined by the city/municipality tax cash flow over a seven-year period. The community return on investment time period projected by the cost-benefit analysis will, in all cases, not exceed seven years.
  - e. Three years of unqualified or clean audits (financial statements) are required for credit worthiness analysis.

Once all metros achieve the targets the tax would be non- discretionary.

- (c) The Minister ***rejects*** the case for introducing new conditions to dedicate the share of fuel levy currently accruing to metropolitan governments to funding transport infrastructure and operations, including public transport. This is because the proposal is neither about reforming the fuel levy nor are arguments justifying this proposal made in the rest of the proposal document. In any case, the Minister of Finance's 2009 Budget Speech and the subsequent Budget Review explicitly *recommended* that the fuel levy funds should be geared towards road and transport infrastructure although in general fuel levy is a general revenue enhancing instrument.
- (d)

## 7. References

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*For and on behalf of the Financial and Fiscal Commission*

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Mr. Bongani Khumalo  
Acting Chairperson/CEO