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DECLARATION

I, Curtly Keagan Stevens, do hereby declare that the dissertation titled: *‘Mitigating the effects of the ever-widening urban fiscal gap plaguing metropolitan municipalities in South Africa: A quest for an additional own-revenue source in the form of a Local Business Tax’* is my original work. All the sources used were properly acknowledged by means of references. I herewith further certify that this paper has not been submitted for another degree or to any other institution of higher learning.

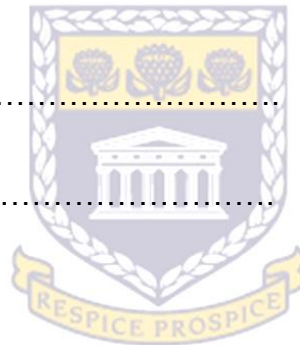
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Dedication

*This dissertation is dedicated to my parents (Maria Stevens and Thomas Stevens),
family and friends.*

A special dedication to my late niece Gretchen De Waal (06.07.05-31.08.17)



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Abbreviations

BLA	Black Local Authorities
BVT	Business Value-Added Tax
CC	Constitutional court
CSL	City Service Levy
FFC	Financial and Fiscal Commission
GRT	Gross Receipt Tax
GST	General Sales Tax
GDP	Gross Domestic Product
HIPA	Helyi iparüzési adó
IRAP	Italian Regional business tax
LG	Local government
LBT	Local Business Tax
MFPFA	Municipal Fiscal Powers and Functions Act, 2007
OECD	Organisation for Economic Co-operation and Development
RSC	Regional Services Council levies
RSCA	Regional Services Councils Act, 1985
SACN	South African Cities Network
SARS	South African Revenue Service
SMME	Small, medium and micro-sized enterprises
VAT	Value Added Tax

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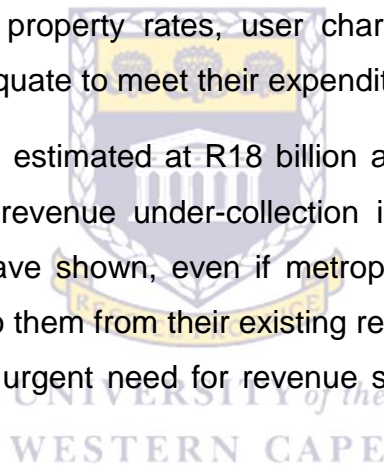
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CHAPTER 1: Introduction

1.1 Problem statement

The prominent role of cities in contemporary developing countries, especially in South Africa, purposively cannot be overstated.¹ Home to 40 per cent of South Africa's population and accounting for 63 per cent of the national gross domestic product (GDP),² cities, in the words of the former Minister of Finance Malusi Gigaba, 'are at heart of the national economy.'³ Yet, despite being at the epicentre of the national economy, cities in the form of metropolitan municipalities (Category A), also known as 'self-standing municipalities',⁴ face a significant mismatch between their expenditure responsibilities and revenue sources.⁵ Not unique to South African cities,⁶ this mismatch, notoriously known as the 'fiscal gap' or 'fiscal imbalance', arises when own revenue sources such as, property rates, user charges, levies and other taxes available to cities, are inadequate to meet their expenditures.⁷

In 2017, this fiscal gap was estimated at R18 billion and projected to grow to R83 billion by 2026.⁸ Whereas revenue under-collection is a known causative factor, several empirical studies have shown, even if metropolitan municipalities (metros) collected all revenues due to them from their existing revenue sources, the fiscal gap would persist.⁹ Despite the urgent need for revenue sources, National Treasury in



¹ South African Cities Network 'Towards an Alternative Financing Model for Metropolitan Cities in South Africa' (2017) available at www.sacities.net/.../201702_Towards_an_alternative_Metropolitan_Municiple_Financ... (accessed on 10 June 2018) 9 and 14-7.

² South African Cities Network 'State of Cities Finance Report' (2018) available at http://www.sacities.net/wp-content/uploads/2018/10/WEB_SACN%20SoCF%20IV.pdf (accessed 12 December 2018) 88.

³ National Treasury 'Annual Budget Speech' (2018) available at <https://www.treasury.gov.za-national-budget> (accessed 10 June 2018) 19.

⁴ *Certification of the Amended Text of the Constitution of The Republic of South Africa, 1996* [1996] ZACC 24 (*Second Certification*) para 77.

⁵ SACN (2018) 91.

⁶ UN-Habitat 'The challenges of local government financing in developing countries' Nairobi: UN Habitat (2015) available at https://sustainabledevelopment.un.org/content/documents/1732The%20Challenge%20of%20Local%20Government%20Financing%20in%20Developing%20Countries%20_3.pdf (accessed on 15 June 2018) 8.

⁷ Slack NE *Guide to Municipal Finance* (2009) 36; see also Litvack L & Jessica S 'Decentralization Briefing Notes' (2010) World Bank Institute available at <https://siteresources.worldbank.org/WBI/Resources/wbi37142.pdf> (accessed 15 May 2018) 28.

⁸ SACN (2018) 91.

⁹ Financial and Fiscal Commission 'Chapter 11: Financing of Urban Municipalities and Own Revenue Diversification' *Submission for the 2018/19 Division of Revenue* (2017) 146; see also SACN (2018) 88.

2006 reduced the revenue raising powers of district and metropolitan municipalities with the abolition of the Regional Services Council (RSC) levies.¹⁰ As a purported a Local Business Tax (LBT), the RSC levies or Joint Services Board levies (as it was known in KwaZulu-Natal),¹¹ was levied against the annual turnover and wage bill of businesses.¹² Although generating 7 per cent, or R6.6 billion of the total local government revenue for the 2005/06 municipal financial year,¹³ experience has shown that the RSC levies amongst other things were flawed due to its high administrative costs and scope for evasion.¹⁴ Moreover, the Katz Commission questioned the constitutionality of the levies on the grounds that the turnover component is a form of general sales tax and the payroll a form of income tax.¹⁵

While these inadequacies are duly noted in the *White Paper on Local Government (1998)*, policymakers directed that the levies be retained, until a suitable alternative revenue instrument which yields the same net revenue is introduced.¹⁶ National Treasury, instead of replacing the levies with a modern local business tax, initially opted to replace the levies in 2006/07 with a national grant of R7 billion and later in the case of metros with a share in the general fuel levy.¹⁷ It is debatable whether the share in the general fuel levy is a suitable alternative replacement for the RSC levies, since it is less buoyant and not linked to any economic activity like its predecessor.¹⁸ Aside from being less buoyant, the inability of metros to set or vary the fuel levy rate weakens the autonomy of metros to act as innovators and visionaries to resolve pressing local issues.¹⁹ Notwithstanding the shortcomings associated with the RSC levies, the eThekweni Metropolitan Municipality, in 2012, applied to the Minister of

¹⁰ National Treasury 'Budget Speech' (2005) available at <https://www.gov.za/budget-speech-2005-minister-finance-trevor-manuel> (accessed 12 June 2018).

¹¹ KwaZulu and Natal Joint Services Act 84 of 1990.

¹² Ministry of Provincial Affairs and Constitutional Development 1998 *White Paper on Local Government* Pretoria: Department of Provincial and Local Government para 2.1.2 (hereinafter *White Paper*).

¹³ Muller L 'The RSC / JSB levy replacement debate' (2008) 9(1) *IMFO: Official Journal of the Institute of Municipal Finance Officers* 22.

¹⁴ Muller (2008) 22.

¹⁵ Katz M *Third interim report of the Commission of Inquiry into certain aspects of the tax structure of South Africa* (1995) 32.

¹⁶ *White Paper* para 2.1.2.

¹⁷ Financial and Fiscal Commission: Sustaining Local Government Finances: *Final Report on the Financial and Fiscal Commission's Public Hearings on the Review of the Local Government Fiscal Framework* (2013) 21 and 41.

¹⁸ Dawood G & Pahwa S 'What will replace RSC levies' (2005) available at www.afrec.co.za (accessed 25 August 2018) 20; FFC (2018) 138.

¹⁹ Van Ryneveld P 'Governing Metropolitan Areas in South Africa' in Steytler N & Ghai YP (eds) *Kenyan-South-Africa Dialogue on Devolution* (2015) 269.

Finance in terms of the Municipal Fiscal Powers and Functions Act, 2007 (MFPFA)²⁰ for the authorisation of a LBT.²¹ While the Financial and Fiscal Commission (FFC) approved the application, the then Minister of Finance, Pravin Gordhan, rejected the application due to the adverse economic environment.

1.2 Significance of the problem

In the current fiscal constrained environment, both theory and practice suggests that the traditional sources of revenue such as property rates or user charges and government transfers cannot reduce the fiscal gap. With a household growth averaging between 22 per cent from 2011-2016, coupled with the fact that property tax bases have remained virtually stagnant for the last decade,²² suggests that metropolitan cities are in need of additional revenue sources. Consequently, if the fiscal gap is not reduce, cities will find it difficult to maintain infrastructure and services that are necessary to attract new investment, business and human capital.²³ This would not only adversely affect the ability of metros to compete within the global economy, but it would also deprive cities of potential revenue streams impeding its growth potential.²⁴ It is against the foregoing backdrop, that the need to assign additional own revenue sources to cities, as a measure to mitigate the effects of the ever-widening fiscal gap becomes critical.

1.3 Research question

The overall purpose of this discourse is to propose a LBT as an additional own revenue source to mitigate the effects of the ever-widening fiscal gap. In pursuance of this overall purpose, this paper will seek to answer the following research question namely;

- a) Will a purported local business tax in the form of a Business Value Added Tax (BVT) pass constitutional muster and be '*appropriate to local government*' as prescribed in terms of section 229(1)(b) of the Constitution?

²⁰ Act 12 of 2007 (hereinafter MFPFA).

²¹ Financial and Fiscal Commission 'Submission on the Application from eThekweni Metropolitan' (2012) available at www.ffc.co.za/.../487-submission-on-ethekwini-application-on-lbt-authorisation-webs... (accessed 10 June 2018).

²² Financial and Fiscal Commission 'Chapter 2: Reviewing the Local Government Fiscal Framework' *Submission for the Division of Revenue 2020/21* (2019) 29 and 36.

²³ Slack (2009) 12.

²⁴ *White Paper* para 2.6.

- b) And if so, how would the tax be structured and administered in terms of section 5 of the MFPFA to realise its benefits and at the same time minimise its deleterious effects?

1.4 Argument

This dissertation argues that the most appropriate LBT currently used and when measured in practice against the norms of a good local tax is a BVT, which in its most simple form, is a tax levied at a uniform rate against labour and capital inputs of businesses. This paper further argues that National Treasury's decision to replace the RSC levies with a share in the fuel levy for metros undermines local fiscal autonomy and accountability insofar as metros are unable to set or vary the fuel levy rate. For a municipal business tax, to pass constitutional muster it must fall outside the ambit of the proscribed taxes, but more so it must be appropriate to local government (LG). After ascribing meaning to section 229 of the Constitution, this paper contends that a LBT, in the form of a BVT is not a proscribed tax, and if properly designed would be appropriate.

The tax recommended in this paper, although based on the model of Bird and under the influence of the developmental objectives of LG, will reward businesses for their job creation and capital investment. While the purported tax would exempt small businesses from the tax, it is argued that with the expansion of the local economy, metros will be able to make-up the shortfall from existing revenue instruments, for example property rates and surcharges for services. The LBT recommended in this paper is not a silver bullet in respect of the fiscal gap but will ameliorate it.

1.5 Literature Review

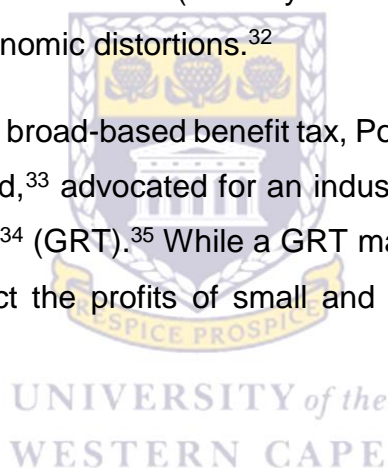
The quest to find additional own revenue sources for cities, or more broadly local government have caught the attention of both local and international scholars.²⁵ Scholars such as Bahl and Linn once suggested four principal solutions to address the fiscal gap, namely: a) increase local government revenue effort; b) increase local government revenue authority; c) increase transfers from higher levels of government; and d) reduce local expenditure responsibilities.²⁶ In a study, the FFC rejected the last two measures, insofar as the dependency on intergovernmental transfers and the

²⁵ SACN (2018) 119; FFC (2018) 141-46.

²⁶ Bahl R & Linn J *Urban public finance in developing countries* (1992) 68.

recentralisation of functions will 'comprise LG autonomy.'²⁷ The Commission's rejection is consistent with international theory which assumes that the most responsive and accountable local governments are those who raise their own revenue and set their own tax rates.²⁸ While the principles that underpin a good local tax is well-established within the literature world,²⁹ the task of who and how a LBT must be structured or is permissible is not clear in principle because it is inextricably linked to political, social, administrative, legal and economic issues.³⁰ Notwithstanding this, Richard Bird, arguably one of the most prominent scholars on this subject matter has found in a number of publications that the most appropriate form of LBT is a broad-based BVT. The proposed tax is levied at a uniform rate against both labour inputs (cost of wages and salaries) and the value added of capital inputs.³¹ Levied at a uniform rate against a broader tax base (not only labour–payroll tax) means that the BVT reduces the cost of economic distortions.³²

Unlike Bird, who argued for a broad-based benefit tax, Pogue, while partially endorsing the BVT as proposed by Bird,³³ advocated for an industry specific tax system in the form of a Gross Receipt Tax³⁴ (GRT).³⁵ While a GRT may lead to higher product and service prices that will affect the profits of small and medium enterprises, Pogue,



²⁷ Financial and Fiscal Commission 'Chapter 4: Incentives Effects of Intergovernmental Grants: Evidence from Municipalities' *Submission for the Division of Revenue 2019/20*(2018) 46 and 76.

²⁸ Bahl & Linn (1992) 45; see also Slack (2009) 22-3; Chigwata T & De Visser J 'Local Government in the 2013 Constitution of Zimbabwe: Defining the Boundaries of Local Autonomy' (2017) *Hague Journal on the Rule of Law* para 2.4.

²⁹ Spahn PB 'Local Taxation: Principles and Scope' (1995) available at <https://mpra.ub.uni-muenchen.de/13111/> (accessed 13 July 2018); see also Slack (2009) 22.

³⁰ Smoke P 'Local Revenues Under Fiscal Decentralisation in Developing Countries: Linking Policy Reform Governance, and Capacity' in Gregory KI & Yu-Hung H (eds) *Fiscal Decentralisation and Land Policies* (2008) 40; see also Bird RM 'Subnational Taxation in Developing Countries: A Review of the Literature' (2010) available at

<http://documents.worldbank.org/curated/en/942791468155366645/Subnational-taxation-in-developing-countries-a-review-of-the-literature> (accessed 15 July 2018) 14 and 23.

³¹ Bird RM 'A Better Local Business Tax: The BVT' (2014) available at <https://munkschool.utoronto.ca/uploads> (accessed 28 August 2018) 6.

³² Bird (2010) 42-3.

³³ Pogue TF 'The Gross Receipt Tax: A New Approach to a Business Taxation' (2007) 4 *National Tax Journal* 802-5.

³⁴ GRT- In its most simple form prescribes that all forms of businesses within a tax jurisdiction must report the value of their receipts to which a tax rate apply to determine the taxable amount.

³⁵ Pogue (2007) 801.

Oakland and Testa are of the view that these shortcomings are not arguments against taxing businesses for the social costs of their activities.³⁶

In comparison to international scholars, not many South African scholars have written on the imposition of a modern LBT in South Africa. Although several local scholars such as Emslie, Moodley, Sing and Heymans have commented on the legal architecture underpinning the RSC levies, these scholars failed to address the deficiencies of the impugned levies.³⁷ While Solomon in South Africa once considered the BVT model proposed by Bird, the author failed to deal with its constitutional permissibility.³⁸ The South African Cities Network (SACN) most recently in a study without prescribing the structure of the tax found that a LBT is implementable in South Africa, but noted that it requires further research.³⁹ A review of the literature reveals that there is no certainty on how a BVT-type tax must be structured, but moreso whether or not it is constitutionally permissible in South Africa. Furthermore, while the BVT is highly favoured by scholars, Bird and Slack noted that the tax might serve as a barrier to economic growth, especially for small businesses.⁴⁰ Thus, the authors proposed that this issue deserves more detailed examination in emerging countries.⁴¹ Acting on this anomaly and taking into account that there is a gap in South African literature on this subject matter, the aim of this paper is to determine whether a BVT-type tax is constitutionally permissible.

1.6 Substantiating the argument

This dissertation is divided into six chapters. Chapter 1, as an introduction, discusses and outlines the problem statement, significance of the problem, research question, argument, literature review and the methodology of the study. Chapter 2 uses the characteristics of a good local tax as a yardstick to identify the most appropriate LBT currently implemented in developed and developing countries. Chapter 3, with

³⁶ Oakland WH & Testa WT 'State-local business taxation and the benefits principle' available at <https://www.chicagofed.org/~media/publications/economic.../epjan96a-pdf.pdf> (accessed 3 June 2018) 2; Pogue (2007) 800-3.

³⁷ Emslie T *Regional levies handbook* 2 ed (1991) 1-77; Moodley S & Sing D 'Local Government Financing in South Africa' in Reddy PS (ed) *Readings in Local Government Management and Development: A Southern African Perspective* (1998) 203; Heymans C 'Local Government Organization and Finance: South Africa' in Shah A (ed) *Local governance in developing countries* (2006) 71.

³⁸ Solomon D 'News and views on regional levies' (2005) 3 *Regional Levies Report* 4-5.

³⁹ SACN (2018) 123.

⁴⁰ Bird R & Slack E 'Metropolitan Public Finance: An Overview' in Bahl R, Linn JF & Wetzel DL (eds) *Financing Metropolitan Governments in Developing Countries* (2013) 147.

⁴¹ Bird (2010) 43.

reference to South Africa, amongst others analyses the legal framework, policy objectives and the reasons behind the abolition of the RSC levies. Chapter 4 examines the constitutional revenue-raising powers of municipalities with the aim of determining whether a BVT will pass constitutional muster. Chapter 5 sets out how a LBT may be structured and implemented in South Africa. Chapter 6 concludes the study with concluding remarks and recommendations.

1.7 Research methodology

The research findings of this paper stems from a desktop study. For the purpose of chapter 2, this paper conducted a comparative study by relying on secondary sources in the form of journal articles, chapters in books and books relating to subnational financing. For the purpose of chapters 3, 4 and 5, this paper relied on primary sources in the form of case law, legislation, statistics and official government reports.



CHAPTER 2: A comparative analysis of the different forms of local business taxes

2.1 Introduction

In the contemporary world, subnational taxation systems provide for a variety of regional and LBTs. This chapter, with particular reference to a selected number of developing and developed countries, will provide a brief overview of the different forms of LBT levied at the local level of government. The aim of this chapter is to use the norms of a good local tax as a yardstick to identify the ideal LBT for South Africa, in the light of international experience and practice. As will be seen below, despite being a constant source of discomfort and critique among policymakers and academics,⁴² a well-established economic principle warrants municipalities to impose a broad-based benefit tax on businesses for the benefit it derives from infrastructure and public services. It will be argued that from the current modalities used in practice, the ideal form of LBT is a broad-based benefit tax levied against the business activities of a business. Despite being a highly recommended, the Business Value Added tax (BVT) is by no means a perfect local tax.

2.2 Taxation Principles

2.2.1 Characteristics of 'Good Local Taxes'

As a point of departure, subnational governments, as prescribed by the traditional theory of fiscal federalism, have a very limited tax base.⁴³ The principal reason for this is because local taxes must comply with a stringent set of tax norms. Public economic literature, below in Table 1, prescribes the following characteristics of a *good* local tax.⁴⁴

Table 1: Characteristics of a good local tax

CHARACTERISTICS	DESCRIPTION
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⁴² Fossen F & Bach S 'Reforming the German Local Business Tax - Lessons from an International Comparison and a Microsimulation Analysis' (2008) 64(2) *Public Finance Analysis* 245.

⁴³ Freire ME & Garzon H 'Managing Local Revenues' in Farvacque VC & Kopanyi M (eds) *Municipal Finances: A Handbook for Local Governments* (2014) 148.

⁴⁴ Freire & Garzon (2014) 149; see also Bird (2010) 22-5; Bahl R, Smoke P & Solomon D 'Overview of the Local Government Revenue system' in Bahl R & Smoke P (eds) *Restructuring local government finance in developing countries: lessons from South Africa* (2003) 72-6.

1	Administration feasibility	The administrative cost burden of the tax must not outweigh the revenue yield. This means that the tax must be administered at a reasonable cost.
2	Correspondence	A correspondence or link must exist between those who bear the tax burden and those who benefit from the services financed by the tax. In other words, the tax burden must not overlap with adjacent municipalities whose residents do not benefit from the tax.
3	Complementary	Local tax must not raise competition or cause harmonisation problems between the spheres of government.
4	Immobility	The tax base should be immobile, broadly speaking, it must be based on assets or activities that are not easily movable to other jurisdictions. This will ensure that municipalities are able to vary the tax rate without losing its taxable base.
5	Economic efficiency	The tax should not promote economic inefficiencies, whereby taxpayers adjust their economic decisions away from the most optimal areas, towards areas where taxation is minimised.
6	Revenue adequacy, elasticity, buoyancy and stability	Revenue yield from the tax should mirror and grow in proportion to expenditures. To maintain the sustainable provision of services the revenue yield should be buoyant during times of economic growth and less vulnerable during economic downturns.
7	Fiscal autonomy	The tax base and rate must have a strong local element to ensure accountability. The most important element is the power to set or vary the tax rate.
8	Equity and Fairness	The tax should be both vertically equitable (i.e. taxpayers with different income levels must pay according to their ability to pay) and horizontally equitable (i.e. those situated in similar economic positions must be treated the same.)

9	Limited horizontal fiscal imbalance	A local tax should not perpetuate large horizontal fiscal disparities amongst municipalities, by giving more to those who have stronger tax bases.
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Source: Bird (2010); FFC (2012); SACN (2018).

The characteristics discussed in Table 1 have been endorsed both internationally and locally.⁴⁵ In practice, it is almost impossible for any revenue instrument to adhere to all these norms. This does not mean that the norms should be ignored altogether, because experience has shown that some taxes are more appropriate and less harmful than others. The characteristics serve as a useful toolkit to assess the appropriateness and practical implications of a local tax.

2.2.2 Benefit Principle: LBT

In theory, the well-established economic principle, the *benefit principle*, also known as '*fiscal equivalence*' allows LGs to tax businesses in the form of a general-benefit tax.⁴⁶ The benefit principle prescribes that where public services are rendered to identifiable beneficiaries these services should be paid directly by those who benefit, preferably through the imposition of user charges.⁴⁷ However, since it is difficult to precisely apportion the extent to which businesses benefit from public services and infrastructure, a broad-based benefit levy on business activities in the form of a tax on value added is admissible.⁴⁸ Against this backdrop, the next section will use the characteristics of a good local tax as a yardstick to identify the most appropriate LBT.

2.3 International experience

2.3.1 Francophone African countries

Several local governments within Francophone African countries, levy a LBT called the *patente* which derived its origin from the French LBT model commonly known as the *Taxe Professionnelle*.⁴⁹ For example, in Côte d'Ivoire, the *patente* is the largest

⁴⁵ Slack (2009) 22; FFC (2012) 7-8; SACN (2018) 115.

⁴⁶ Bird (2003) 22.

⁴⁷ Bahl R & Bird RM *Fiscal Decentralization and Local Finance in Developing Countries: Development from Below* (2018) 165.

⁴⁸ Freire & Garzon (2014) 173; see also Slack (2011) 6; Smoke (2008) 46 and Fossen & Bach (2008) 269.

⁴⁹ Fjeldstad OH 'Local Revenue Mobilization in Urban Settings in Africa' (2018) available at <https://www.cmi.no/publications/file> (accessed 19 September 2018) 11-2.

revenue source for the city of Abidjan.⁵⁰ The structure and calculation of the tax is multifaceted with a fixed rate that varies and applies to the value of business premises, number of employees, turnover and value of machinery used. The rental value of business premises is by far the largest factor that contributes to the tax base, resulting in the *patente* functioning like a property tax.⁵¹

Similar taxes also exist in Morocco and Tunisia wherein the former, the *patente* is levied at a rate ranging between 5 to 30 percent against a firm or individual's business rental value. Unlike Morocco, the Tunisian LBT is levied at a rate of 0.05 percent against a firm's gross income.⁵² On face value, the *patente* ought to be administered easily since it is levied against visible indicators, however in practice it is fairly difficult to administer, because of its complex structure, especially the tax register which must be updated annually.⁵³

2.3.2 Anglophone African countries

In Tanzania, urban councils levy a local business tax called the City Service Levy (CSL). The levy is imposed at a fixed rate of 0.1 percent on banks or financial sectors' turnover and for other firms 0.3 percent.⁵⁴ The levy is paid quarterly by Value Added Tax (VAT) registered businesses and annually by small businesses.⁵⁵ Although being a significant source of revenue for urban councils, administering the CSL is problematic due to insufficient data collections and poor maintenance of the tax register.⁵⁶ To overcome this problem the Tanzanian Revenue Authority proposed that the CSL should be collected as part of the VAT or corporate income tax. This proposal was rejected by urban councils out of concern that the central government may either abolish or retain the revenue derived from the CSL.⁵⁷

2.3.3 Latin America

Local business taxes are common own revenue sources in Latin America. In fact, Brazil has a long history for levying LBT, whereby the current GRT, commonly known

⁵⁰ Freire & Garzon (2014) 173.

⁵¹ Fjeldstad (2018) 12.

⁵² Bird RM 'Local Business Taxes' in Bird R & Vaillancourt F (eds) *Perspectives on Fiscal Federalism* (2006) 238.

⁵³ Bird (2006)238.

⁵⁴ Fjeldstad (2018) 12.

⁵⁵ Fjeldstad (2018) 12.

⁵⁶ Fjeldstad (2018) 12.

⁵⁷ Fjeldstad (2018) 12.

as the *imposto sobre servicios* (ISS), dates back to the 19th century.⁵⁸ As a local services activity tax, the ISS is a GRT levied on all firms and independent professionals for services, excluding transportation and communication services. While the Brazilian federal government initially determined both the tax rate and base, in recent years municipalities were empowered to set its own rate within the maximum rate as set by the federal government.⁵⁹ The tax rate varies between 2 and 5 per cent, generating twice as much revenue as the local property tax. In Colombia, the municipal industry and commerce tax (*industria y comercio*) generate 40 percent of LG revenue.⁶⁰ Operating as a GRT, local governments within a certain limit can determine the tax rate and base usually ranging from 0.2 to 1 percent on a firm's gross receipts.⁶¹ Local governments in Ecuador and Chile are allowed to levy a LBT against a firm's net wealth at a rate of 3 percent in the case of the former and the latter between 2.5 and 5 percent.⁶²

2.3.4 European countries

Within the European Union several countries impose some form of business tax at the local level of government which contributes between 15 and 30 percent of LG revenue.⁶³ Amongst the most common forms of LBT used in the Organisation for Economic Co-operation and Development (OECD) countries inter alia is a local business profit tax (*impôt commercial*) levied in Luxembourg at a rate of between 6 and 9 percent on a firm's operating profits. In Austria, local authorities levy a local payroll tax (*kommunalsteuer*) at a rate of 3 percent set by national government.⁶⁴ Some local business taxes are levied on business properties, for example the Business and Professional Activities tax (*impuesto sobre actividades económicas*) levied in Spain.⁶⁵

Another often-cited LBT model which is highly recommended by scholars, namely tax on local value added, exists in Hungary, Germany, Italy⁶⁶ and most recently France.

⁵⁸ Bird (2006) 235

⁵⁹ Bahl & Bird (2018) 354-6.

⁶⁰ Bahl & Bird (2018) 355.

⁶¹ Freire & Garzon (2014) 173.

⁶² Freire & Garzon (2014) 173.

⁶³ Freire & Garzon (2014) 172.

⁶⁴ Fossen & Bach (2008) 249.

⁶⁵ Fossen & Bach (2008) 252-5.

⁶⁶ A regional business value-added tax also exists in Italy known as the *imposta regional a sulle attività produttive* (IRAP), calculated on the annual sales revenue less cost of intermediate goods or services, whereby purchases inputs from other firms are subject to depreciation.

For example, the German trade tax or *gewerbesteuer* labelled as the 'grandfather of all local business value added taxes'⁶⁷ is a LBT dating back to the 1930s⁶⁸ which in its original form was a tax levied against all factors of production. However, since the inception of the tax in the 1930s several reforms led to the erosion of the tax base. The payroll and capital components of the tax were effectively abolished in 1980 and 1984 respectively leaving the operating profit attributed to local jurisdictions as the main revenue source of the tax.⁶⁹ In its current form, the *gewerbesteuer* is a tax that is largely dependent on the profits of businesses rendering it highly volatile as a revenue instrument. Policymakers in Germany are considering reforming the trade tax by introducing either a pure profit or origin value added tax. However, as it stands, the tax remains largely unreformed.⁷⁰ A similar LBT exists in Hungary known as the *helyi iparüzési adó* (HIPA) which is levied at a local determined rate of up to 2 percent on a base of local gross value added calculated according to the subtraction method - sales revenue, excluding VAT, less cost of goods sold, materials and subcontractors. Like all the other taxes, the HIPA is not perfect to the extent that it perpetuates disparities and is fairly costly to administer.⁷¹

In 2010, the French government abolished the *taxe professionnelle* which in its original form was a tax levied against the rental value of a firm's equipment and wage bill. Subjected to many criticisms the payroll component of the tax was eroded in 2003. The professional tax was replaced in 2010 by the economic territorial contribution tax (*contribution économique territoriale*). The tax consists out of two bases each subject to different rules namely, tax levied against the annual rental value of properties used for business purposes (*Cotisation Foncière des Entreprises*) and value-added base at a rate of 1.5 percent (*Cotisation sur la valeur ajoutée des entreprises*). The value-added base is calculated as the difference between annual turnover and the cost of services and goods used in the business. The revenue derived from the value-added tax is divided between departments and amongst the two levels of LG.⁷²

⁶⁷ Bird (2014) 8.

⁶⁸ Fossen & Bach (2008) 255.

⁶⁹ Fossen & Bach (2008) 256.

⁷⁰ Bird (2014) 10.

⁷¹ Bird (2014) 14.

⁷² Bird (2014) 15.

2.4 Overview: Key shortcomings

The LBT modalities discussed above are not an exhaustive list.⁷³ From the plethora of local business taxes, most scholars agree that the current modalities do not score well against the appropriateness criteria.⁷⁴ For instance, most of the local business taxes perpetuate fiscal disparities between localities, whereby more revenue is given to those with strong tax bases. Moreover, businesses are being taxed in clear violation of the correspondence principle, insofar as the tax burden exceeds business benefits.⁷⁵ The Austrian payroll tax serves as a barrier to employment, especially during economic downturns.⁷⁶ The *patente* levied at different rates against a firm's capital inputs, for example machinery and rental value, distorts business spending decisions and depresses investment. Most of the taxes are fairly costly to administer. The Tanzanian City Services levy, for example, requires the same information to be submitted to the central government for corporate income purposes. The duplication of the data systems results in high levels of compliance cost for both the private and public sector.⁷⁷

Notwithstanding these shortcomings, experience from various countries has shown that LGs are likely to continue to tax businesses. Aside from the benefit principle, LGs tax businesses for the following two reasons. First, as an elastic revenue source, LBT is more responsive to economic growth raising substantial revenue, especially in large cities. Second, since it is unclear who bears the tax burden, local citizens favour the imposition of LBT in the belief that businesses will bear the brunt of the tax, thereby rendering it politically acceptable.

2.5 Bird's recommended model: The BVT

It has become settled practice for LGs around the world to tax businesses. A strong economic justification supports local authorities for doing so through the usage of a

⁷³ A similar tax exists in Japan, known as the Enterprise Tax (tax base consists out of a number of components. For example, value added tax is levied at a rate of 0.48 percent – defined as salaries, net interests, rent and minus or plus profits).

⁷⁴ Slack E 'Financing Large Cities and Metropolitan Areas' (2011) *Institute on Municipal Finance and Governance* available at: https://munkschool.utoronto.ca/wp.../Slack_FinancingLargeCities_IMFG_20111.pdf (accessed 26 September 2018) 9; see also Bird (2010) 40.

⁷⁵ Bird (2010) 40.

⁷⁶ Freire & Garzon (2014) 173.

⁷⁷ Fjeldstad & Heggstad (2012) 11-2.

broad-based general tax in the form of a value-added tax.⁷⁸ A tax on local value added exists in Germany, Hungary, France, Japan and Italy. The model labelled as the BVT proposed by Bird, which was once considered in South Africa,⁷⁹ requires one to combine the cost of labour (wages and salaries) and the value-added of capital inputs, which is the cost of capital (debt and equity). The tax base may be calculated according to the subtraction method (annual sales revenue minus cost of labour, capital and other purchase inputs), subject to depreciation.⁸⁰

Unlike the traditional VAT, which is a tax on consumption, the BVT is a tax on business income (generated from sales revenue) levied from an origin basis, which is the place of production (location of the seller). Where a business operates within one jurisdiction the BVT in line with the correspondence principle is payable only within that jurisdiction. Conversely, if a business operates within more than one jurisdiction the business value added will be calculated and apportioned between localities from an origin basis, based on their sales revenue, payroll and capital inputs. Since the tax is assessed on the annual returns of businesses, and not net-income (profits), means that the BVT is not a corporate income tax. The exclusion of imports from the tax base and the inclusion of exports show that the BVT is not a sales tax, but a tax that falls on business activities.⁸¹

Compared to other taxes, the BVT would improve the current tax system in the following ways: First, due to its broader tax base, unlike payroll taxes, which are levied against one input (labour), the BVT is levied at a lower uniform rate against both labour and capital inputs reducing the cost of economic distortions. Second, since a BVT is responsive to economic conditions an implicit incentive is imposed on LGs to encourage economic growth. Finally, levied against a uniform defined tax base, the BVT promotes fiscal autonomy by allowing local authorities to set or vary the tax rate within a pre-determined regulated tax range. Allowing local authorities to vary the tax rate within a maximum and minimum range will reduce the abuse of over-taxing and tax competition between localities.⁸²

⁷⁸ Bird (2010) 40.

⁷⁹ Solomon D 'News and views on regional levies' *Regional Levies Report* (2005) 3 4-5; see also National Treasury 'Options for the Replacement of RSC and JSB levies' (2005) 5.

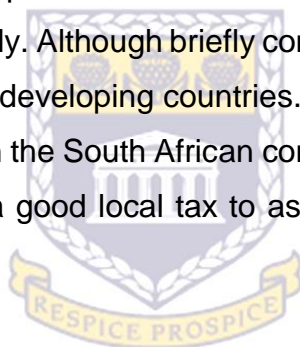
⁸⁰ Bahl & Bird (2018) 204.

⁸¹ Bahl & Bird (2018) 205.

⁸² Bird (2010) 42-3.

2.6 Conclusion

This chapter sketched the different LBT modalities currently used in both developing and developed countries. Using the norms of a good local tax as a yardstick, it seems generally accepted that the plethora of modalities do not score well. All local business taxes, including the BVT perpetuate fiscal disparities between localities by giving more to those with strong tax bases. Compared to the other modalities, the BVT is by no means a perfect local tax. It is, however, less harmful and more appropriate to the extent that it reduces the cost of economic distortions since it is levied at a single uniform rate on labour and capital. Assessed against the annual returns of businesses, the tax could be administered alongside the corporate income tax or VAT. Weighing the advantages of the BVT against its shortcomings, it is reasonable to conclude that the BVT is arguably the most appropriate LBT. This model is currently used in Germany, France, Hungary, Japan and Italy. Although briefly considered in South Africa, the BVT notably does not feature within developing countries. Before determining whether the BVT model is permissible within the South African constitutional framework,⁸³ the next chapter will use the norms of a good local tax to assess the appropriateness of the former RSC levies.



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⁸³ Smoke (2008) 39.

CHAPTER 3: An analysis of the Regional Services Council levies

3.1 Introduction

The Regional Services Councils Act (RSCA)⁸⁴ adopted in 1985 once allowed metropolitan and district municipalities to levy a LBT, known as the Regional Services Council levies (RSC levies).⁸⁵ Levied against the gross receipts (annual turnover) and wage bill of businesses, the RSC levies generated a sizable amount of revenue for metros. Despite this, National Treasury decided to abolish the impugned levies in 2005 and replaced it, in the case of metros, with a share in the general fuel levy.⁸⁶ This chapter, in light of the norms of a good local tax, will seek to determine whether the Minister's decision to abolish the levies and replace it with a share in the general fuel levy was justifiable. Relying on the norms of a good local tax, it is contended that the Minister's decision to abolish the RSC levies was justifiable. Replacing the impugned levies, however, with a less buoyant revenue source, in the form of a share in the general fuel levy for metros was inappropriate, insofar as it undermines local fiscal autonomy to the point that metros are unable to set or vary the fuel levy rate.

Due to the complexity of the legal architecture underpinning the RSC levies, this chapter will focus on a selected number of provisions, namely the administrative powers and fiscal autonomy of councils. Before embarking on this inquiry, the chapter will first discuss the policy objectives behind the formation of the RSC levies. Thereafter, the appropriateness of the RSC levies will be assessed.

3.2 RSC levies: An apartheid invention

It is well documented that financial shortfalls were purposefully built into the apartheid local government system to preserve and advance the interests of affluent white urban municipalities to the detriment of black local authorities.⁸⁷ Unlike, affluent white municipalities, who had a large concentration of economic resources to tax and small populations to serve, Black Local Authorities (BLAs) formed under the Black Local Authorities Act⁸⁸ had limited resources to tax so as to generate adequate revenue to

⁸⁴ Act 109 of 1985 as amended by Regional Services Councils Amendment Act 102 of 1986.

⁸⁵ Note, while the RSC levies were abolished in 2006, s 59(2)(3) of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006 entitles District and Metropolitan councils to collect outstanding levies up to 30 June 2006 provided that a summons for collection has been issued before 30 June 2008.

⁸⁶ National Treasury 'Budget Speech' (2005).

⁸⁷ *White Paper* para 1.

⁸⁸ Act 102 of 1982.

provide meaningful service delivery.⁸⁹ The financial imprint which characterised local authorities during apartheid was concisely described by the Constitutional Court (CC) in the *Fedsure* judgment in a *dictum*:

historically “White” areas are characterised by infrastructure development, thriving business districts and so called “Black”, “Coloured” and “Indians” areas, by contrast plagued by underdevelopment, poor services and vastly inferior rates bases.⁹⁰

In an attempt to address the appalling social and economic conditions, the apartheid government in 1985, through the promulgation of the RSCA, sought to reduce the political tension in black areas by redirecting funds to collapsing BLAs through the formation of Regional Services Councils (RSC).⁹¹ As ‘multi-racial decision-making bodies’,⁹² one of the primary functions of the Councils was to render bulk services to underdeveloped local authorities.⁹³ To achieve this objective, Councils were empowered to impose two levies on the annual turnover and payroll of businesses within delineated regions.⁹⁴

3.3 Legal Framework: Key provisions

3.3.1 Limited Fiscal autonomy

The RSCA, as the enabling legislative instrument read with the regulations issued under the Act,⁹⁵ makes provision for the levying of two levies, namely, a regional services levy (commonly known as the payroll tax) and the regional establishment levy (turnover tax).⁹⁶ Prior to the 1986 amendment, section 12(1)(b) empowered regional councils to determine the taxable rate of both tax bases, subject to the ‘*concurrence*’ of the Minister of Finance. The position changed with the amendment of the principal Act, to the extent that the Minister of Finance had the power to determine the levy rates, after he or she ‘consulted’ the Council for the Co-ordination of Local Government Affairs.⁹⁷ In other words, the Minister could have determine or vary the levy rates

⁸⁹ *White Paper* para 1.

⁹⁰ *Fedsure Life Assurance Ltd and Others v Greater Johannesburg Transitional Metropolitan Council and Others* 1998 (12) BCLR 1458 (CC) (*Fedsure*) para 2.

⁹¹ For a comprehensive discussion on the origin of RSC see Cameron R ‘Regional Services Councils in South Africa: Past, Present and Future’ (1993) 71(3) *Public Administration* 417–39.

⁹² Steytler N & De Visser J *Local Government of South Africa* (2017) para 1.8.

⁹³ Section 3(1)(b) read with Schedule 2 RSCA.

⁹⁴ Section 2 RSCA.

⁹⁵ Calculation and payment of Regional Services Levy and Regional Establishment Levy GN R340, 17 February 1987.

⁹⁶ Sections 12(1)(a)(i)-(ii) RSCA.

⁹⁷ Sections 1 read with s 12(1)(b) RSCA as amended by s 8 of Act 78 of 1986.

without the *concurrence* or *consensus* of the Regional Councils. While the Minister was required to consult the Co-ordination Council, its powers was limited to making non-binding recommendations.⁹⁸ Consequently, the ultimate prerogative to determine the levy rates and tax base vested in the Minister of Finance.

3.3.2 Limited administrative powers

Arguably, the greatest shortcoming associated with the RSC levies related to the enforcement powers vested in councils. While councils were responsible for the collection of the levies, it was noticeable for the empowering provisions to afford limited enforcement and compliance powers to councils. For instance, the Regional Services Amendment Act⁹⁹ unequivocally prohibited councils from requesting books, records, accounts or other documents to substantiate any returns submitted.¹⁰⁰ As a result, Councils as the collecting authority could not independently verify what a levy-payer had to pay, but could only direct the matter to the Commissioner for Inland Revenue.¹⁰¹ This means, as observed by Bahl and Solomon, 'that the tax base was self-declared' rendering the levies to act as a 'donation' and not a tax.¹⁰²

Prior to the *Cable City (Pty) Ltd*¹⁰³ judgment, councils were empowered to summarily estimate the liability of levy-payers, in particular if a levy-payer failed to submit returns within the prescribed period.¹⁰⁴ The Supreme Court of Appeal (SCA) in the *Cable City* judgment, per Maya JA, writing for a unanimous court, held that this power was unlawful for being *ultra vires* for the following reason:

Considering the Act as a whole and the wording of s 12, the implication appears ineluctable that the Legislature never intended councils to have power to summarily estimate levies and did not grant the Minister authority to permit such exercise.¹⁰⁵

From this judgment, one may authoritatively conclude that councils were precluded from summarily estimating levies due and requesting the books of levy-payers to assess their tax liability.¹⁰⁶ Notwithstanding the weak enforcement powers, councils

⁹⁸ Section 4 of the Promotion of Local Government Affairs Act 91 of 1983.

⁹⁹ Act 78 of 1986.

¹⁰⁰ Section 12(1A)(1)(b) of RSCAA read with paragraph 13(1) of *GN R340*, 17 February 1987.

¹⁰¹ Paragraph 13(2) of *GN R340*.

¹⁰² Bahl R & Solomon D 'The Regional Service Council Levy' in Bahl R & Smoke P(eds) *Restructuring local government finance in developing countries: lessons from South Africa* (2003) 131.

¹⁰³ *City of Tshwane Metropolitan Municipality v Cable City (Pty) Ltd* [2009] ZASCA 87 paras 1 and 17.

¹⁰⁴ Paragraph 11.1 of *GN R340*.

¹⁰⁵ *Cable City* para 24.

¹⁰⁶ *Cable City* para 22.

were empowered to impose a fine or criminal sanction (imprisonment not exceeding twelve months) or both on any levy-payer who failed to pay.¹⁰⁷

3.3.3 Were the RSC levies a 'Local Tax'?

As a precursor for the discussion below, it is essential to determine whether it is correct to label the RSC levies as a local tax. Ever since the inception of the impugned levies, our courts have not, as a matter of principle labelled the RSC levies as a tax. However, the SCA in *Eskom v Bojanala Platinum District Municipality and Another*¹⁰⁸ assumed that the RSC levies was a tax, without conclusively labelling it as such. It must be noted, that the court's assumption was qualified to the extent that the RSC levies must be due, properly assessed and payable.¹⁰⁹ In *Master v IL Blake & Co Ltd* case, Galgut AJA defined a tax as 'a pecuniary charge imposed by a public authority upon persons or property for public purposes but may also be called a "levy" or "duty" ...'.¹¹⁰ For a levy to be a tax, our courts over the years developed the following distinguishing features:

- a) it must be compulsory, not optional;
- b) imposed or executed by a competent authority;
- c) be enforceable in law;
- d) imposed on the public as whole or a substantial sector thereof, and
- e) revenue derived must be utilised for the public benefit and interests.¹¹¹

The Constitutional Court (CC) recently in the *Shuttleworth* judgment noted that legislative instruments often use terms such as tax, levy, duty or surcharge interchangeably.¹¹² Beyond the aforementioned features, the CC, per Moseneke DCJ, writing for the majority, developed the following test:

So, aside from mere labels, the seminal test is whether the primary or dominant purpose of a statute is to raise revenue or to regulate conduct. If regulation is the primary purpose of the revenue raised under the statute it would be considered a

¹⁰⁷ Section 12(9) RSCA.

¹⁰⁸ 2005 (4) SA 31 (SCA).

¹⁰⁹ *Bojanala* para 8.

¹¹⁰ 1983 (1) SA 986 (A) 1000H.

¹¹¹ *City of Johannesburg v Renzon and Sons (Pty) Ltd* 2010 (1) SA 2016 (W) 215F-H; *Maize Board v Epol (Pty) Ltd* 2008 71 SATC 236 para 27.

¹¹² *South African Reserve Bank and Another v Shuttleworth and Another* 2015 (8) BCLR 959 (CC) (*Shuttleworth*) para 43.

fee or charge rather than a tax. The opposite is also true. If the dominant purpose is to raise revenue then the charge would ordinarily be a tax.¹¹³

The court correctly observed that there is no bright lines between the two, because every tax is in some measure regulatory.¹¹⁴ Thus, one must carefully consider the dominant purpose of a statute by answering the primal question: 'what is the dominant purpose of the revenue-raising law to raise revenue to fund the operations of the State, or to regulate behaviour or defray costs or advance another legitimate purpose?'¹¹⁵ In light of the dominant purpose test, it is apparent that the dominant purpose of the RSCA was not regulate the behaviour of levy-payers. In fact, the Act sought to establish and regulate the powers and functions of regional councils. Moreover, reading the Act along with its regulations, it is apparent that the dominant purpose of the RSCA was to raise revenue to finance the operations of Councils. This is clear from the detailed nature of the regulations issued in terms of the Act, which amongst others prescribed the tax base and formula to calculate the levy rate. Accordingly, it is reasonable to label the RSC levies as a tax, however not a pure local tax. This submission is based on the fact that the tax rate, base and levy-payers' liability were not determined by councils, but by the Minister of Finance and in the case of the latter, Commissioner of Inland Revenue. That said, the next section will measure the RSC levies against the appropriateness criterion discussed in chapter 2.2.1.

3.4 Measuring the RSC levies against the "Appropriateness Criterion"

3.4.1 Administrative feasibility

The requirement of administrative feasibility prescribes inter alia that the tax should be fairly easy to administer and collectible at a reasonable cost. Measuring the RSC levies against this requirement, I submit that the levies did not score well for the following reasons: First, the RSC levies had a high scope for evasion due to the inability of councils to inspect the books of levy-payers and summarily estimate levies due. Second, while councils were empowered to impose fines on non-payers, it is contended in the absence of proper assessment powers the overall effectiveness of section 12(9) of the RSCA is questionable. Since, councils did not have access to the

¹¹³ *Shuttleworth* para 48.

¹¹⁴ *Shuttleworth* para 48.

¹¹⁵ *Shuttleworth* para 64.

books of levy-payers, it could not determine whether levy-payers were indeed liable for unpaid levies, and if they were, for what amount.

3.4.2 Non-exportability/Immobile

To ensure that local authorities have the discretion to vary the tax rate without losing its tax base, it is generally recommended that the tax base must be immobile.¹¹⁶ To prevent local authorities from exporting the tax burden to non-residents, the immobility requirement together with the correspondence principle, prescribes that the tax burden must lie where expenditure benefits falls. Like other LBT modalities on gross receipts and payroll, the RSC levies violated the correspondence principle. For example, firms who provided goods and services nationally, failed to apportion their turnover tax liability to individual authorities. Firms often paid their taxes to the collecting authority or jurisdiction where their head officers were situated.¹¹⁷ The exportation of the tax burden to non-residents incentivised the jurisdiction of Head Officers to overspend because the collecting authority was not accountable to non-residents. A good local tax related to the correspondence principle must have a minimal distorting effect on business-operating decisions. Both taxes bring about economic inefficiencies, insofar as the payroll tax is bias against labour intensive firms. The turnover tax favours vertically integrated firms, because firms who have vertically integrated some of its production processes have been proven to pay less turnover taxes than their counterparts.¹¹⁸

3.4.3 Revenue adequacy and elasticity

A local tax must yield revenue that is adequate to meet local needs. In addition, the revenue yield must be elastic and buoyant, automatically growing over time in proportion to the expenditure responsibilities of local authorities.¹¹⁹ As with most forms of business taxes, the RSC levies cannot be faulted for not being a good elastic revenue source. Prior to its abolishment in 2006, it was estimated that the RSC levies for the 2005/06 municipal financial year generated R7 billion.¹²⁰ As seen from the

¹¹⁶ Bird (2010) 21.

¹¹⁷ Bahl & Solomon (2003) 142-3.

¹¹⁸ Bahl & Solomon (2003) 139.

¹¹⁹ Bahl & Smoke (2003) 73.

¹²⁰ National Treasury & South African Revenue Service '2008 Tax statistics' (2008) available at <http://www.treasury.gov.za/publications/tax%20statistics/2008/2008%20Tax%20Statistics%20%20full%20version.pdf> (accessed 27 October 2018) 15.

Table 3 below, the RSC was a fairly elastic and buoyant revenue source, particularly for metropolitan municipalities.

Table 3: Revenue from Regional Services Council levies, 1999–00 to 2003–04¹²¹

District councils R million	1999–00	2000–01	2001–02	2002–03	2003–04
Eastern Cape	217	223	121	135	141
Free State	142	148	165	171	197
Gauteng	367	368	146	171	214
KwaZulu-Natal	189	198	203	186	263
Limpopo	84	84	90	111	196
Mpumalanga	202	217	248	282	305
Northern Cape	140	140	62	54	84
North West	55	55	126	154	185
Western Cape	126	132	143	155	207
Subtotal	1 521	1 567	1 303	1 419	1 791
<i>Percentage growth</i>		3,0%	-16,9%	8,9%	26,2%
Metros					
Eastern Cape	–	–	142	149	180
Gauteng	1 095	1 098	1 692	1 876	2 369
KwaZulu-Natal	270	283	210	323	135
Western Cape	500	527	562	654	749
Subtotal	1 865	1 908	2 606	3 001	3 433
<i>Percentage growth</i>		2,3%	36,6%	15,2%	14,4%
Total	3 386	3 474	3 908	4 421	5 224
<i>Percentage growth</i>		2,6%	12,5%	13,1%	18,2%

Source: National Treasury

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As illustrated above, the RSC levies was an important own revenue sources for metros and district municipalities, generating 7 percent, or R5.2 billion of total LG revenue in 2003-04. Of this, two-thirds of the RSC levies collected came from the six metropolitan municipalities. The city of Johannesburg collected R1.7 billion, confirming the fact discussed under part 3.4.2, that most companies paid their taxes to municipalities where their head offices were situated.¹²²

3.4.4 Fiscal disparities

Like most local business taxes, the RSC levies accentuated rather than reduced fiscal disparities between localities. An empirical study conducted by Bahl and Solomon

¹²¹ National Treasury 'Trends in intergovernmental Finances' (2004) available at https://cisp.cachefly.net/assets/articles/attachments/01354_intergovfinance.pdf (accessed 7 July 2019) 27-8.

¹²² National Treasury (2004) 28.

found amongst other things, that metros raise more revenue from the levies than district municipalities, even if the latter's tax rate was higher.¹²³

3.4.5 Fiscal autonomy and Accountability

For a tax to be labelled, as a local tax it is essential for the tax base and rate to be visible to ensure accountability.¹²⁴ Put somewhat differently, to ensure accountability local authorities must at least have the power to alter the tax rate, as remarked by Chigwata and De Visser: '[l]ocal taxing powers are likely to be of little relevance for revenue mobilisation and fiscal autonomy, if they are not accompanied by the right to set tax rates.'¹²⁵ As discussed above in light of section 12(1)(b) of the RSCA as amended, the ultimate authority to set or alter the RSC levies rates from time to time vested in the Minister of Finance.

3.4.6 Equity and Fairness

The requirement of fairness in relation to taxation is premised on two concepts, namely, vertical and horizontal equity.¹²⁶ Vertical equity seeks to determine whether a tax treats taxpayers situated at different income levels according to their 'ability to pay'. Under a vertical equity arrangement, the tax instrument may either be progressive, that is taxing the rich more than the poor, or regressive (same tax rate applies to the rich and poor). Conversely, horizontal equity seeks to determine whether a tax treats taxpayers situated in a similar economic position in the same manner.¹²⁷ On a vertical scale, the RSC levies were regressive because the tax burden was not levied according to levy-payers' ability to pay because the same tax rate applied to all businesses, subject to a few exemptions. On the other hand, the levies were horizontally inequitable due to its weak assessment and collection for the reason that firms who found themselves in the informal sector, known as the 'hard to catch' were not paying tax even if their annual turnover exceeded that of their counterparts in the formal sector.¹²⁸

¹²³ Bahl & Solomon (2003) 147.

¹²⁴ Bird (2010) 21; Bahl & Smoke (2003) 75.

¹²⁵ Chigwata T & De Visser J 'Local Government in the 2013 Constitution of Zimbabwe: Defining the Boundaries of Local Autonomy' (2017) *Hague Journal on the Rule of Law* para 2.4.

¹²⁶ Biitir BS & Assiamah JK 'Mobilising sustainable local government revenue in Ghana: modelling property rates and business taxes' (2015) 16(17) *Commonwealth Journal on Local Governance* 227.

¹²⁷ Bahl & Smoke (2003) 74.

¹²⁸ Bahl & Solomon (2003) 138.

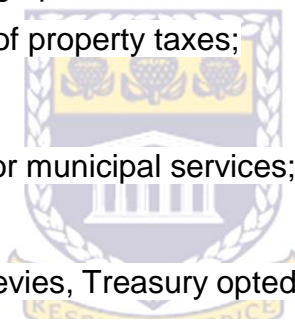
3.5 Replacement: Share in Fuel levy

Ever since the inception of the RSC levies, economists and commentators predicted and called for its abolishment.¹²⁹ Despite generating 7 percent or R5 billion of total LG revenue in the 2003/04 municipal fiscal year, the then Minister of Finance, Trevor Manuel, amongst others, criticised the levies for being a poorly administered revenue instrument which had a high scope for evasion.¹³⁰ While these inadequacies are noted politically, the *White Paper on Local Government* states the following policy position:

'Despite these problems, these taxes are an important source of municipal revenue, and will need to be retained, at least until such time as a suitable alternative, yielding the same net revenue, is introduced.'¹³¹

The admitted deficiencies prompted National Treasury to replace the levies with one or a combination of the following options:

- a) Value-added tax zero rating of property taxes;
- b) LBT;
- c) business licence fee;
- d) surcharge on user charges for municipal services; and
- e) replacement grant.¹³²



As a replacement for the RSC levies, Treasury opted initially to replace the levies with a national grant of R7 billion and later, in the case of metros with a share in the general fuel levy.¹³³ The share in the fuel levy was not destined to replace the levies indefinitely, but merely to serve as an interim measure to consider all the options.¹³⁴ In 2009, the share in the fuel levy calculated from an origin basis according to the fuel sales within metros was permanently assigned to metros as a replacement for the levies.¹³⁵ Although the share of the fuel levy is statutory¹³⁶ assigned to metros and viewed by government as 'municipal own revenue source', it is disputed that it is not a suitable alternative replacement for the RSC levies for the following two reasons: Foremost, unlike the RSC levies, the fuel levy is less buoyant to the extent that it does

¹²⁹ Solomon D (2005) 1.

¹³⁰ Budget Speech (2005).

¹³¹ *White paper* para 2.1.2.

¹³² National Treasury 'Options for the Replacement of RSC and JSB levies' (2005) 5.

¹³³ FFC (2013) 21.

¹³⁴ FFC (2013) 21 and 41.

¹³⁵ National Treasury Explanatory Memorandum to the Budget Review (2012) available at <http://www.treasury.gov.za/documents/national%20budget/2012/review/Annexure%20W1.pdf> (accessed 14 December 2018) 47.

¹³⁶ Section 109 read with Schedule 1 of the Taxation Laws Amendment Act 17 of 2009.

not capture or grow in proportion with economic growth.¹³⁷ Second, local fiscal autonomy and accountability is undermined because metros are not allowed to set or vary the fuel levy rate.¹³⁸

3.6 Conclusion

Evaluating the RSC levies against the appropriateness yardstick, it seems generally accepted that the levies scored high for revenue elasticity, especially the turnover component. Despite scoring well on revenue elasticity, the RSC levies failed to comply with the following characteristics for a good local tax:

- a) was not easy to administer (councils lacked administrative powers);
- b) violated the correspondence principle (tax exporting);
- c) Economically inefficient (bias against labour intensive firms and favoured vertically integrated firms);
- d) undermined local fiscal autonomy (tax rate and base were not determined by councils, but by the Minister of Finance);
- e) due to weak administration, horizontal equity was undermined because the levies failed to capture the 'hard to tax' in the tax base; and
- f) perpetuated fiscal disparities between municipalities.

These shortcomings draw me to the unavoidable conclusion that the RSC levies were an inappropriate local tax. Consequently, the decision of the Minister of Finance to abolish the levies was justifiable. It does not follow that the decision to replace the levies with a share in the fuel levy for metros was appropriate, because as shown the fuel levy is less buoyant and undermines local fiscal autonomy and accountability. Given the inadequacies associated with the RSC levies and taking into account that National Treasury once opted to replace the RSC levies with a local business tax, the next chapter, will determine whether a purported LBT is permissible within the South African constitutional framework.

¹³⁷ FFC (2018) 138; see also Dawood & Pahwa (2005) 20.

¹³⁸ Van Ryneveld (2015) 269.

CHAPTER 4: Constitutional Framework: Municipal revenue-raising powers

4.1 Introduction

The tax assignment principles and norms of a local tax previously discussed in Chapter 2 are useful to develop and assess the appropriateness of a local tax. Yet, the task of developing a local tax, as once noted by Bird, is not clear in principle, because it inextricably links to political, economic and legal issues.¹³⁹ This chapter, therefore aims, to identify and analyse the legal requirements that a municipal tax must meet in order for it to be permissible within the Constitution. More specifically, what is the BVT model discussed in Chapter 2 ‘appropriate to local government’ as prescribed in terms of section 229(1)(b) of the Constitution? In order to answer this question, the constitutional revenue-raising powers of municipalities will first be discussed. Then an interpretive framework will be developed in accordance with section 229 of the Constitution and the Municipal Fiscal Powers and Functions Act (MFPFA).¹⁴⁰ Owing to the limited scope of this paper, the chapter will mainly focus on the ‘additional own revenue sources’ that may be assigned to municipalities.

4.2 Local Government taxation powers: Section 229 of the Constitution

4.2.1 Original and Authorised Revenue sources

Unlike provinces, which are largely dependent on national grants to finance their functions, municipalities, especially metros enjoy a high level of financial independence. Apart from deriving their revenue from ‘intergovernmental transfers’ in the form of an equitable share of revenue raised nationally and through conditional and unconditional grant allocations,¹⁴¹ metros mainly finance their budgets from ‘own revenue sources.’¹⁴² The right of a municipality to govern on its own initiative¹⁴³ finds expression in the fiscal autonomy it is guaranteed in section 229(1) of the Constitution, which prescribes:

- (1) Subject to subsections (2), (3) and (4), a municipality may impose—

¹³⁹ Bird (2010) 14 and 23.

¹⁴⁰ Act 12 of 2007.

¹⁴¹ Section 227(1)(a)-(b) Constitution.

¹⁴² SACN (2017) 25-6.

¹⁴³ Section 151(3) Constitution.

- (a) rates on property and surcharges on fees for services provided by or on behalf of the municipality; and
- (b) if authorised by national legislation, other taxes, levies and duties appropriate to local government or to the category of local government into which that municipality falls, but no municipality may impose income tax, value-added tax, general sales tax or customs duty.

The Constitution distinguishes between own revenue sources directly derived from the Constitution and that which is authorised by national legislation. The power of municipalities to impose rates on property and surcharges on user fees are known jurisprudentially as ‘original powers.’¹⁴⁴ Although subject to legislative regulation, the overall existence of the original revenue powers is not dependent on enabling legislation, since it is derived from the Constitution.¹⁴⁵ Fortifying the fiscal autonomy of municipalities, section 160(2) of the Constitution prohibits municipal councils from delegating its revenue generating powers. This means that the power to impose rates and taxes is a ‘legislative act that may only be exercised by democratically-elected representatives after due deliberation.’¹⁴⁶ In addition to the original revenue powers, section 229(1)(b) of the Constitution allows municipalities to impose other taxes, levies and duties, subject to national legislative authorisation. Unlike the original revenue powers, municipalities do not have a constitutional entitlement to additional taxing powers. In contrast to the additional provincial taxation powers of provinces, whose exercise is dependent on ‘national regulatory legislation’,¹⁴⁷ the power of municipalities to impose other taxes only arises if national legislation ‘authorises it’.

4.2.2 Limited taxation powers

It is a fundamental principle of our constitutional order that all public power, which includes the power to impose taxes, is subject to constitutional control. Reiterating this principle, Ngcobo J in the *Affordable Medicines* judgment held that:

The exercise of state power must comply ... with the Constitution ... and the doctrine of legality ... which is an incident of the rule of law. It entails that both the legislature and the executive are constrained by the principle that they may

¹⁴⁴ *City of Cape Town and Other v Robertson and Other* [2004] ZACC 21 (*Robertson*) para 56; see also *Fedsure* paras 35 and 39.

¹⁴⁵ *Robertson* para 60.

¹⁴⁶ *Fedsure* para 45.

¹⁴⁷ Section 228(2)(b) Constitution; see also *Certification of the Constitution of the Republic of South Africa 1996* 1996 (10) BCLR 1253 (CC) (*First Certification*) para 438.

exercise no power and perform no function beyond that conferred upon them by law.¹⁴⁸

With reference to the taxation powers of government, Moseneke DCJ in the *Shuttleworth* judgment in a *dicta* held that '[i]t is plain that in our jurisdiction a decision or law that purports to impose a tax will be invalid to the extent of its inconsistency with the limits imposed by the Constitution or other law.'¹⁴⁹ It is therefore trite law, both the original and authorised revenue powers of municipalities must comply with the Constitution and legislation. This is clear from the language use in subsections 229(1)(b) and 229(2)(a) of the Constitution. With reference to the additional revenue powers, section 229(1)(b) and (2)(a) of the Constitution prescribes that:

(b) ... other taxes, levies and duties appropriate to local government or to the category of local government into which that municipality falls, but no municipality may impose income tax, value-added tax, general sales tax or customs duty.

(2) The power of a municipality to impose rates on property, surcharges on fees for services provided by or on behalf of the municipality, or other taxes, levies or duties—

(a) may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour; and

(b) may be regulated by national legislation.

4.3 Legal Requirements: Authorised revenue powers

The following four requirements must be comply with in order for a municipal tax to be assign to municipalities:¹⁵⁰ First, the additional taxation power must be authorised by national legislation. Second, the tax must be appropriate to LG or a category of LG.¹⁵¹ Third, the tax must not fall within the ambits of the proscribed taxes, namely: income tax, value added tax, general sales or customs duty. Last, the tax must not be exercise in a manner that materially or unreasonably prejudice macroeconomics. The substance of these requirements will be discussed below.

¹⁴⁸ *Affordable Medicines Trust and Others v Minister of Health and Another* [2005] ZACC 3 paras 48-9; see also *Fedsure* para 56.

¹⁴⁹ *Shuttleworth* para 42.

¹⁵⁰ Sections 229(1)(b) and (2) Constitution.

¹⁵¹ Section 155(1)(a)-(b) Constitution read with s 2 and 3 of the Local Government: Municipal Structures Act 117 of 1998 establishes the following three municipal categories: Category A - refers to metropolitan municipalities, who have exclusive executive and legislative authority in their areas. Unlike Category A municipalities, both Category B (local municipalities) who falls within the area of Category C (district municipalities) share their executive and legislative authority with each other.

4.3.1 National legislative authorisation

In 2007, Parliament, in pursuant to sections 229(1)(a) and (b) of the Constitution, promulgated the MFPFA. The objectives of the Act are amongst other things, to provide a legislative framework for the authorisation and regulation of taxes that a municipality may impose, if authorised to do so.¹⁵² The Act in itself does not create or prescribe a list of taxes. However, it merely allows the Minister of Finance through the usage of regulations to authorise the imposition of a municipal tax.¹⁵³ The Act establishes two authorisation procedures: First, the Minister may out of his or her own accord, authorise a municipal tax provided that he or she has consulted the Minister for LG, affected municipalities and organised local government and the FFC.¹⁵⁴ The second procedure allows a municipality, a group of municipalities or organised local government to submit an application to the Minister for the authorisation of a municipal tax.¹⁵⁵ An application must comply with various requirements as outlined in the Act ranging from the reasons for the tax, utilisation of revenue and whether the tax complies with s 229(1)(a) and 2(a) of the Constitution.¹⁵⁶

Although the Minister is under a statutory duty to consult with all the interested parties giving effect to the principle ‘that there shall be no taxation without representation,’¹⁵⁷ the requirement of ‘consultation’ does not mean that the Minister is duty-bound to give effect to the wishes of those with whom he or she has consulted.¹⁵⁸ It does not follow that the Minister may simply refuse to grant the requisite authorisation, especially if all the requirements in section 5 of the MFPFA are satisfied. In other words, while the Minister’s act of authorisation constitutes an executive action, it is settled law that the exercise of executive authority must be rationally connected with the purpose for which the power was conferred.¹⁵⁹

¹⁵² Section 2(d)(ii)(iii) MFPFA.

¹⁵³ Sections 4(4) and 6, MFPFA.

¹⁵⁴ Section 4(2)(a) MFPFA.

¹⁵⁵ Sections 4(1) and 5, MFPFA.

¹⁵⁶ Section 5 MFPFA.

¹⁵⁷ *Shuttleworth* para 42.

¹⁵⁸ For the meaning of ‘consultation’, see Steytler N & De Visser J ‘Local Government’ in Woolman S & Bishop M (eds) *Constitutional Law of South Africa* (2013) 2 ed 90-2.

¹⁵⁹ *Democratic Alliance v President of the Republic of South Africa and Others* 2012 (12) BCLR 1297 (CC) paras 29-32; see also Steytler & De Visser (2013) 89.

4.3.2 Proscribed taxes

It is common cause that a municipal tax that falls within the scope of one of the proscribed taxes namely, income tax, value added tax, general sales tax and customs duty will be susceptible to being declared invalid. This interpretation is mandated by section 229(1)(b) of the Constitution and is further buttressed by the principles of cooperative government.¹⁶⁰ As an organ of state that falls within the local sphere of government,¹⁶¹ municipalities are constitutionally bound to respect the powers of the other spheres. This includes the taxation powers of the national and provincial government. In other words, a municipality may not assume the taxation powers or exercise its taxation powers in a manner that encroach on the functional integrity of the other spheres.¹⁶² Strictly speaking, any municipal tax that falls within the ambit of the proscribed taxes will not only contravene section 229(1)(b), but it would also violate the principles of cooperative government.¹⁶³

Although the Constitution expressly limits municipalities from imposing income tax, VAT, general sales tax (GST) and customs duty,¹⁶⁴ the proscribed taxes are notably not defined in the Constitution. Notwithstanding this anomaly, the ideal point of departure¹⁶⁵ is to construe the ordinary meaning of the taxes through the prism of the Constitution and wherever plausible give the proscribed taxes a purposive restrictive meaning.¹⁶⁶ Such an interpretive approach will widen the scope of the national government to assign additional revenue sources to LG, in so doing enabling it to fulfil its constitutional and statutory obligations fully and effectively.¹⁶⁷

a) Income tax

An income tax is commonly defined as a direct tax levied against a person's earned wages, salaries or unearned income (dividends, rents, interests) and in the case of a

¹⁶⁰ Sections 41(1)(e)-(g) Constitution.

¹⁶¹ Sections 40(1) and 41 Constitution; *Uthukela District Municipality & Others v President of the Republic of SA & others* [2002] JOL 9855 (CC) paras 18-9.

¹⁶² Sections 41(1)(e)-(g) Constitution.

¹⁶³ *Ex parte President of the Republic of South Africa: in re: Constitutionality of the Liquor Bill 2000* (1) BCLR 1 (CC) paras 41-2.

¹⁶⁴ Section 229(1)(b) Constitution.

¹⁶⁵ *Metropolitan Life Ltd v Commissioner for South African Revenue Service* (2008) 70 SATC 162 para 32.

¹⁶⁶ *CDA Boerdery (Edms) Bpk en Andere v Nelson Mandela Metropolitan Municipality* [2007] ZASCA 1 (CDA Boerdery) para 29; *Shuttleworth* para 51.

¹⁶⁷ *City of Johannesburg Metropolitan Municipality v Gauteng Development Tribunal and Others* [2010] ZACC (GDT) 11 para 61.

company, a tax levied against its profits.¹⁶⁸ Unlike municipalities who are prohibited from imposing an income tax, the Constitution unequivocally prohibits provinces from imposing a flat surcharge on the corporate income tax.¹⁶⁹ As shown above, the ordinary meaning of an income tax is wide enough to encompass both a personal income tax and corporate income tax. This means that an income tax as envisaged in the Constitution refers to both a personal and corporate income tax as levied in terms of the Income Tax Act.¹⁷⁰

b) VAT

The value added tax is not always labelled as such. For example, in Australia, Canada, New Zealand and Singapore the VAT is known as a 'goods and services tax.' While the tax rate and base of the VAT may differ from country to country, a value added tax according to its description, is a tax levied against the value added to a product or service by a business at each stage of the production and distribution chain.¹⁷¹ Despite being levied and collected at each stage of production, firms within the production chain may offset the tax against the purchase price paid by the final consumer. This means that the ultimate burden of the tax is passed on to the final consumer.¹⁷² Distinguishing the VAT from an income tax, Dambuza JA in the *Marshall N.O.* judgment held: '[T]he liability to charge VAT ... does not depend on the profitability or outcome of the transaction because VAT is not a tax on business profits or turnover, but on consumption.'¹⁷³

c) General sales tax

As a consumption-based tax, a GST is levied against the sales of all goods or services that is assessed and collected at one stage, which is when the commodity or service is supplied for final use or consumption.¹⁷⁴ In other words, unlike the VAT that is

¹⁶⁸ 'Income Tax' available at <http://www.businessdictionary.com/definition/income-tax.html> (accessed 8 December 2018).

¹⁶⁹ Section 228(1)(b) Constitution.

¹⁷⁰ Section 1 of the Income Tax Act 58 of 1982 prescribes that income tax is imposed as a normal tax payable annually against a person's or a company's 'taxable income' calculated by deducting exempt income and allowable deductions from the gross income of a taxpayer.

¹⁷¹ Stiglingh M 'Value-added tax' in Stiglingh M, Silke A & Smit W Silke (eds) *South African income tax 2014* (2014) 1038.

¹⁷² Stiglingh (2014) 1038.

¹⁷³ *CSARS v Marshall NO* [2016] ZASCA 158 para 16.

¹⁷⁴ *Marshall* para 16.

assessed and collected at each stage of production, a GST is assessed and collected at the point of sale.¹⁷⁵

d) Customs duty

A customs duty is generally defined as an indirect tax levied on goods and services imported into a country.¹⁷⁶ In South Africa, different forms of customs duties are levied in terms of the Customs and Excise Act.¹⁷⁷

4.3.3 Constitutional meaning: Appropriate to LG

National government's discretionary power to assign additional taxation powers to LG is limited insofar as the tax, levy or duty must be 'appropriate to local government or a category.'¹⁷⁸ The appropriateness yardstick is not defined in the Constitution or legislation. The requirement stems from constitutional principle XXV that prescribed:

The framework for local government referred to in Principle XXIV shall make provision for appropriate fiscal powers and functions for different categories of local government.¹⁷⁹

In the *First Certification* judgment, the Constitutional Court¹⁸⁰ invoked the abovementioned principle and found amongst other things, the initial text unconstitutional to the extent that section 229(1) allowed municipalities to levy excise taxes. Excise tax is defined as an inland duty imposed on goods or services manufactured locally which is intended for local consumption.¹⁸¹ While the court earmarked excise taxes as 'inappropriate',¹⁸² it is argued that the court failed to prescribe a criterion to determine whether a local tax is an 'appropriate fiscal instrument.' The only guidance to be drawn from the court's reasoning is that taxes imposed on mobile bases, for example, goods such as alcohol, tobacco or fuel levied

¹⁷⁵ Davis Tax Committee *Final Report VAT* (2018) available at <http://www.taxcom.org.za/docs/20180329%20Final%20DTC%20VAT%20Report%20to%20the%20Minister.pdf> (accessed 12 December 2018) 12.

¹⁷⁶ De Lange C 'Customs duty' in Stiglingh et al (eds) *Silke: South African Income Tax 2014* (2014) 1126.

¹⁷⁷ Act 91 of 1964.

¹⁷⁸ Section 229(1)(b) Constitution.

¹⁷⁹ Schedule 4 of the Constitution of the Republic of South Africa, Act 200 of 1993.

¹⁸⁰ *Certification of the Constitution of the Republic of South Africa, 1996* [1996] ZACC 26 (*First Certification*) para 301.

¹⁸¹ De Lange (2014) 1131.

¹⁸² *First Certification* paras 303-5.

at different rates at a municipal level will lead to inter-jurisdiction competition, which will affect the mobility of goods and services.

a. Interpretive approach

The historical development of the different interpretive approaches adopted over the years is encapsulated in a long line of cases. The current position in our law was succinctly described in the oft-cited *Endumeni* judgment as follows:

Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, ... having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production ...¹⁸³

In other words, 'interpretation is no longer a process that occurs in stages but is essentially one unitary exercise.'¹⁸⁴ Therefore, irrespective of the nature of the document,

'[t]he inevitable point of departure is the language of the provision itself', read in context and having regard to the purpose of the provision and the background to the preparation and production of the document.'¹⁸⁵

Guided by this interpretive approach, it is argued that the phrase 'appropriate to local government' must not be construed in isolation but in the context of section 229 of the Constitution, and the Constitution as a whole, having due regard to the history and background of the adoption of the Constitution.¹⁸⁶

b. Constitutional context

The word 'appropriate' in its ordinary dictionary meaning may be defined as 'something that is suitable or fitting to a particular situation.'¹⁸⁷ In the context of section 229(1)(b) of the Constitution a distinction is drawn between when a tax is appropriate to LG or a category of LG into which a municipality falls. Local government is commonly defined

¹⁸³ *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (SCA) (*Endumeni*) para 18.

¹⁸⁴ *Bothma-Batho Transport (Edms) Bpk v S Bothma & Seun Transport (Edms) Bpk* [2014] 1 All SA 517 (SCA) para 12.

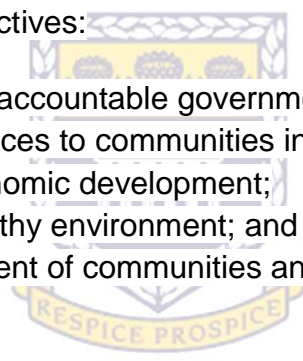
¹⁸⁵ *Endumeni* para 18.

¹⁸⁶ *S v Makwanyane and Another* [1995] ZACC 3 paras 10 and 263.

¹⁸⁷ 'Appropriate' available at <https://www.collinsdictionary.com/dictionary/english/appropriate> (accessed 5 December 2018).

as the closest sphere of government to the people who are responsible for the administration of various essential public services. Within the context of the Constitution, LG has a technical meaning defined as a 'local sphere of government which consists out of municipalities' that is divided into three categories, namely: category A, B and C.¹⁸⁸ Consequently, 'appropriate to local government' means that an additional tax is suitable or fitting to all three categories, as opposed to a single category.

Whether a tax is appropriate to LG or a category, our constitutional scheme dictates that the phrase must be interpreted through the prism of the developmental objectives of LG, having due regard to the functions that are assigned to each category.¹⁸⁹ As a response to the destructive role-played by LG in the past, the Constitution mandates LG to realise the following objectives:

- 
- a) provide democratic and accountable government for local communities;
 - b) ensure provision of services to communities in a sustainable manner;
 - c) promote social and economic development;
 - d) promote a safe and healthy environment; and
 - e) encourage the involvement of communities and organisations in the matters of LG.¹⁹⁰

These developmental objects show that the drafters of the Constitution purposefully elevated LG to a constitutional order in favour of a new vision,¹⁹¹ to address the mischief in which municipalities are no longer used to implement segregation and exploitation but act as 'key agents of development.'¹⁹² Given the deep division in our towns and the scars of spatial apartheid,¹⁹³ municipalities bear an important responsibility to provide services in a sustainable manner to realise the constitutional goal to 'improve the quality of life of all citizens.'¹⁹⁴ However, as observed by Bosielo JA 'for a municipality to execute its constitutional and statutory obligations it requires sufficient resources and revenue.'¹⁹⁵ With this in mind, the primary objective of section

¹⁸⁸ Section 155(1)(a)-(c) Constitution.

¹⁸⁹ Sections 155(1)(a) read with 156(1)(a) Constitution.

¹⁹⁰ Section 152(1)(a)-(e) Constitution.

¹⁹¹ *Fedsure* para 38.

¹⁹² Steytler & de Visser (2017) 21.

¹⁹³ *Mkontwana v Nelson Mandela Metropolitan Municipality* [2004] ZACC para 105.

¹⁹⁴ Preamble of the Constitution.

¹⁹⁵ *Rademan v Mqohaka Municipality & Others* [2012] JOL 28591 (SCA) para 9.

229(1)(b) is to empower the national government in line with its duty of support,¹⁹⁶ to assign additional revenue powers to municipalities to enable it to fulfil its constitutional obligations 'fully and effectively.'¹⁹⁷ The provision read with section 227(2) of the Constitution reinforces the notion of local accountability requiring municipalities to finance their functions from local revenue sources.

c. Elements of Appropriate Municipal Tax

In light of this constitutional scheme, it is submitted that a purported LBT will be 'appropriate to LG or category' if it gives effect to the developmental objectives of LG. The appropriateness criteria developed below shows that there is a strong nexus between the norms of a good local tax¹⁹⁸ and the developmental objectives of LG. Using these norms as a guideline, a municipal tax is appropriate to 'category A municipalities' if it complies with the following requirements:

- a. *Permissibility*: a municipal tax must not fall within the ambits of one of the proscribed taxes namely; income tax, VAT, GST or customs duty;¹⁹⁹
- b. *Local accountability*: To promote accountable local government, a strong nexus must exist between the tax instrument and municipal expenditure responsibility.²⁰⁰ To enhance local accountability, municipalities must at least have the discretion to vary and set the tax rate. These two elements will ensure that local communities are able to hold municipalities accountable for the value-for-money of services provided;
- c. *Revenue adequacy, buoyancy and stability*: The tax instrument, if properly administered, must yield adequate revenue to ensure that municipalities are able to provide services in a sustainable manner.²⁰¹ Adequacy means that the tax revenue must mirror and grow in proportion to the expenditure responsibilities of municipalities. The sustainability of services will require the tax revenue to be stable and buoyant, that is, grow during times of economic growth and be stable during economic downturns;

¹⁹⁶ Section 154(1) Constitution.

¹⁹⁷ *GDT* para 49 and 61.

¹⁹⁸ See Chapter 2.

¹⁹⁹ Section 229(1)(b) Constitution.

²⁰⁰ Section 152(1)(a) Constitution.

²⁰¹ Section 152(1)(b) Constitution.

- d. *Social and Economic development*: Any municipal tax together with point C above must be used and structured in a way to foster social and economic development.²⁰² While it is not the direct responsibility of LG to create jobs, a municipal tax must be structured to be conducive to investment and labour;²⁰³
- e. *Fiscal disparities*: Given the economic disparities produced by apartheid, a municipal tax must not perpetuate fiscal disparities between municipalities;
- f. *Immobility of base*: Related to point B above, a local tax must be based on immobile factors to enable municipalities to increase the tax rate without losing its tax base. The requirement of immobility may be inferred from the deliberate exclusion of mobile tax bases, for example income tax, VAT, GST and customs duty.²⁰⁴ If these taxes are assigned to municipalities and imposed at different rates, tax competition is likely to arise which will distort the economic decisions of taxpayers to relocate to areas where taxation is minimised; and
- g. *Administrative feasibility*: Lastly, the tax should be easily administered and collectible at a reasonable cost. The duty to involve local communities in the LG affairs implies that the administrative cost burden for both the collecting agent and taxpayer should be taken into account. There is no constitutional requirement that obliges municipalities to administer the tax, thus the national government may collect the tax on behalf of municipalities.²⁰⁵

4.3.4 Taxation impact

A local tax may be appropriate in its design but is may be rendered inappropriate if it is implemented in a manner that causes material and unreasonable prejudice to national economic policies, economic activities across municipal boundaries or national mobility of goods, services, capital or labour.²⁰⁶ There is still uncertainty in our law as to whether or not the requirements envisaged in s 229(2)(a) of the Constitution are justiciable. The Supreme Court of Appeal in the *Mbunduzi* judgment²⁰⁷ had to determine, amongst other issues, whether the court *a quo* was correct in exempting property set aside for low-income housing purposes from property rates. The court a

²⁰² Sections 152(1)(c) and 153(1)(a) Constitution.

²⁰³ Section 229(2)(a) Constitution.

²⁰⁴ Section 229(2)(a) Constitution.

²⁰⁵ Section 154(1) Constitution.

²⁰⁶ Section 229(2)(a) Constitution.

²⁰⁷ *Mbunduzi Municipality v MEC of KwaZulu-Natal Province for Housing and Another* [2004] 2 All SA 11 (SCA) (*Mbunduzi SCA*) para 24.

quo found that the failure to do so would prejudice the Member of the Executive Council (MEC) to develop low-income housing, which is a national policy.²⁰⁸ The Supreme Court, per Brand JA, rejected the court *a quo*'s reasoning by saying the following: 'the function to decide whether the exemption of the property rates will be in conflict with national priority is one which falls outside the province of the court.'²⁰⁹ Subsequent to the *Msunduzi* matter, the Supreme Court in the *CDA Boerdery* judgment was afforded another opportunity to clarify whether s 229(2)(a) is justiciable. Determining whether the drastic increase in rates on agricultural land would be inconsistent with national economic policy, Cameron JA writing for the majority like the court *a quo* expressed its reservations on its justiciability. While the Court found it unnecessary to express any final view on the issue, the Court nevertheless provided the following two reasons:

First, the primary remedy for any alleged breach of s 229(2)(a) lay in the hands of national and provincial government, and not in aggrieved litigants taking direct recourse to the courts; and, second, because the courts are not best placed to decide the questions of economic policy at issue in the provision.²¹⁰

The following conclusions can be drawn from the two judgments. First, where a municipal tax is exercised in a manner that falls foul of the proscribed tax behaviour, courts will be reluctant to intervene because each sphere of government has a duty to avoid legal proceedings against each other.²¹¹ Moreso, courts are not best placed or equipped to deal with polycentric issues. To enforce the precepts of sound taxing practice, Steytler and De Visser once recommended the national government to use its regulatory powers in section 229(2)(b) to prescribe beforehand the tax behaviour that would fall foul of section 229(2)(a) of the Constitution.²¹²

4.4 Is the BVT a proscribed tax?

This section will determine whether a purported BVT discussed in Chapter 2, falls within the ambit of one of the proscribed taxes. Apart from the consumption base VAT, a number of developing countries allow subnational governments to impose a net-income type VAT. For example, municipalities in Hungary alongside the consumption

²⁰⁸ *MEC for KwaZulu-Natal Province for Housing v Msunduzi Municipality* [2003] 1 All SA 580 (N).

²⁰⁹ *Msunduzi SCA* para 25.

²¹⁰ *CDA Boerdery* paras 45-6.

²¹¹ Section 41(1)(h)(vi) Constitution.

²¹² Steytler & De Visser (2013) 94.

type VAT levied by national government, are permitted to impose a net-income type VAT at the local level of government, called HIPA. The tax base is calculated by using the subtraction method – net turnover derived from goods sold or services provided during a given period, minus the purchase price of the goods sold, the value of intermediary services and the cost of materials. The European Court of Justice in 2007 in the *Kögaz and Others*²¹³ judgment authoritatively upheld the HIPA by distinguishing it from the consumption VAT on the following grounds:

First, unlike the conventional VAT which is limited to the value added at a particular stage, the HIPA concerns the overall turnover of the taxable person, minus those elements identified above.²¹⁴ Second, since the HIPA base is calculated on periodic turnover, it is not possible to determine the precise amount that will be passed on to the client or final consumer, like the consumption type VAT.²¹⁵

Prior to the *Kögaz* judgment, the European Court of Justice, in the *Banca Popolari di Cremona* judgment ruled, on the same basis, that the Italian Regional business tax (IRAP) is not a VAT but a tax charged against the net-value of production.²¹⁶ Notwithstanding the persuasive value of these judgments, the distinguishable features delineated above are consistent with the remarks of Dambuza JA, in which the learned judge held that VAT is not a tax on business profit or turnover, but on consumption.²¹⁷ It follows that a LBT based on the net-turnover, assessed against the annual gross receipts of a business, rather than its net-income (profits), and levied from an origin basis (place of production) is not an income tax, VAT or a GST. Accordingly, the Minister may within the ambits of s 229(1)(b) of the Constitution assign a BVT-type tax to LG, if it is *appropriate*.

4.5 Conclusion

This chapter developed a constitutional interpretive framework with the aim of determining whether metropolitan municipalities are permitted, in terms of section 229(1)(b) of the Constitution, to impose a LBT at the local sphere. Finding that an additional municipal tax must broadly satisfy four requirements, which amongst others includes legislative authorisation and appropriate to local government or a category,

²¹³ *Kögaz and Others* C-283/06 and C-312/06 (2007).

²¹⁴ *Kögaz* para 47.

²¹⁵ *Kögaz* paras 40 and 52.

²¹⁶ *Banca popolare di Cremona Soc. coop. arl v Agenzia Entrate Ufficio Cremona* C-475/03 (2006) para 30.

²¹⁷ *Marshall* para 16.

the next chapter will propose how a purported BVT may be structured and administered in South Africa. Given that the highly recommended LBT, known as the BVT was found judicially not to fall within the ambit of the proscribed taxes, this chapter argued that the BVT model could be assigned to metropolitan municipalities, on condition that it substantially complies with the constitutional appropriateness yardstick developed in this chapter.



CHAPTER 5: Proposals for a local business tax (LBT) in South Africa

5.1 Introduction

Following on from Chapter 4, which found amongst others that it is constitutionally permissible for a LBT to be imposed at the local sphere, this chapter will seek to explain how a LBT may be structured and implemented in South Africa. In doing so, this chapter will first consider the LBT modalities previously considered in South Africa, especially the models proposed by the eThekweni Metropolitan Municipality. In light of the different modalities used in practice, this chapter will argue for the imposition of a production-based LBT, which like most LBT is by no means a perfect local tax.

5.2 eThekweni Metropolitan Municipality: Section 5 MFPFA application

5.2.1 Background

South Africa's metropolitan municipalities, as discussed in Chapter 1, face a significant mismatch between their expenditure responsibilities and their revenue sources. This mismatch coupled with stagnant property tax bases,²¹⁸ which is exacerbated by rapid urbanisation, threatens the overall ability of metros to realise its developmental mandate.²¹⁹ In order to reduce the fiscal gap and combat stagnant property tax bases, the eThekweni Metropolitan municipality lodged a formal application to the Minister of Finance for the authorisation of an additional revenue source in the form of a LBT.²²⁰ The merits of the proposal was considered by the FFC after the then Minister of Finance, Pravin Gordhan, in accordance with his statutory duty duly sought the advice of the Commission.²²¹

5.2.2 Local Business Tax: eThekweni models

a. Production-Based model

Although being structured in technical terms as a national tax, the 'local business tax for economic infrastructure and services'²²² was in essence a local tax because of strong local characteristics.²²³ In other words, while the South African Revenue

²¹⁸ FFC (2019) 29 and 36.

²¹⁹ Section 152 of Constitution.

²²⁰ Section 5 of MFPFA.

²²¹ Section 4(2)(a)(ii) of MFPFA.

²²² Financial and Fiscal Commission 'Submission on the Application from eThekweni Metropolitan Municipality for the authorisation of a Local Business Tax' (2012) available at www.ffc.co.za/.../487-submission-on-ethekweni-application-on-lbt-authorisation-webs... (accessed 10 June 2018).

²²³ FFC (2012) 7.

Service (SARS) would have administered the proposed tax, the revenue would have accrued to metros in accordance with a tax rate set or varied by metros within a range determined by the Minister of Finance. The eThekweni LBT proposal was essentially two taxes, namely: production-based and turnover tax.²²⁴

The production-based model is a LBT levied against all factors of production used by a business in the course of its activities. Factors of production or resources in economic terms refer to inputs or resources used to produce goods or services. The tax will be levied at a uniform rate against capital inputs which refer to the machinery, building, tools and equipment employed in the production of a business which depreciates overtime.²²⁵ In addition, labour services or input is represented by salaries and wages of employees. The tax is levied from an origin basis which is the location of capital and labour services used by businesses within a municipal jurisdiction. The tax base may be determined in several ways. The simplest method is the subtractive method - sales revenue minus total purchases from other registered businesses (excluding VAT). Alternatively, expenditure incurred on factors of production may be added together (additive method).

b. Turnover model

The turnover LBT is levied as an origin-based tax, that is, all goods and services supplied by taxpayers within a municipality will be subject to the tax, regardless of the fact that some goods may be exported or services rendered to non-residents. The amount subject to the LBT is the annual sales revenue generated from taxable supplies of a particular business as defined in the Value-Added Tax Act.²²⁶ Like the production-based model, the turnover tax will not apply to small business that falls below the turnover VAT threshold.

5.3 Application's outcome

5.3.1 FFC findings

The FFC, after measuring the eThekweni proposed tax against the characteristics of a good local tax, found that both models do not appear to score well against the norms

²²⁴ Section 5(1)(e) MFPPFA.

²²⁵ 'Factors of production' available at <http://www.businessdictionary.com/definition/factors-of-production.html> (accessed 3 December 2018).

²²⁶ The services provided by financial institutions must be included into the definition of taxable supplies.

of a good local tax.²²⁷ Notwithstanding this, the Commission recommended that the Minister approve the proposal in principle.²²⁸ Whilst the Commission aptly endorsed the proposal for the imposition of a LBT for metropolitan municipalities²²⁹ the following inadequacies were highlighted:

- a) Like most business taxes, the purported LBT will perpetuate, rather than reduce fiscal disparities between localities, even amongst metros;
- b) The tax is likely to put pressure on employers to increase salaries and wages; and
- c) Lastly, the tax is likely to be regressive, meaning that it is levied at a uniform rate on businesses, regardless of their ability to pay.²³⁰

5.3.2 Minister's views

The Minister of Finance rejected the eThekweni proposal citing the adverse economic environment as the reason for the rejection of the application.²³¹ While the Minister rejected the formats proposed by the City of eThekweni, it is important to note that the Minister did not rule out the possibility of a LBT being implemented in South Africa. In addition, to the adverse economic environment, the Minister rejected both formats on the basis that the LBT is levied on a narrow base, insofar as it applies only to businesses that are registered for VAT. One must concede that the exclusion of businesses which falls below the VAT turnover threshold would reduce the LBT base for some municipalities. However, the exclusion of small and medium enterprises from the tax base is consistent with the government's policies aimed at promoting small, medium and micro-sized enterprises (SMMEs).

Apart from the aforementioned reason, the Minister was of the view that when considering a new municipal tax, cognisance must be given to the existing revenue sources available to municipalities weighed against their service delivery and developmental mandates, as well as their revenue performance. From the list of requirements or factors to consider in section 5 of the MFPFA, it is apparent that the aforementioned requirements which the Minister based his decision upon were not factors which the Minister ought to have taken into account.²³² It is therefore contended

²²⁷ FFC (2012) 11.

²²⁸ FFC (2012) 12.

²²⁹ FFC (2012) 7-8.

²³⁰ FFC (2012) 8-12.

²³¹ SACN (2018) 111.

²³² Section 5(1)(a)-(j) MFPFA.

that the exercise of the Minister's executive authority and his decision of refusal, may fall foul of the rationality test to the extent that the decision was based on irrelevant considerations.²³³

5.4 Recommended model: BVT

5.4.1 Tax on production

The LBT model recommended below derived its origin from the BVT proposed by Bird.²³⁴ A similar model is currently used in countries such as Germany, Hungary, France, Italy and Japan. Whereas the proposed model is in technical terms structured in the same manner as the eThekweni business footprint model, the LBT model recommended in this chapter will have a built-in job creation and capital investment incentive programme to mitigate the adverse impact which the tax is likely to have on employment and investment.

5.4.2 Rationale

The economic activities of businesses impose a considerable cost burden on municipalities, especially infrastructure and service-related costs, for example transport infrastructure. Since it is difficult to apportion the exact benefit which a business derives from infrastructure and municipal services, international practice suggests that a broad-based benefit levy on business activities is justifiable.²³⁵ It is therefore ideal to tax businesses based on their business footprint or their overall impact on the use of such infrastructure and services. The overall impact on the use of infrastructure and services which a business makes use of during their operations is well-captured in a production-based LBT.

5.4.3 Origin based tax

As an origin-based tax, the proposed LBT must be levied at a uniform rate against all factors of production used by a business at its place of production. Unlike a business tax which is imposed on one input, for example labour (payroll tax), the production-based LBT will be less distorting since it is imposed at a uniform rate on all factors of production. The factors of production will include both labour inputs (salaries and

²³³ *Freedom Under Law v National Director of Prosecutions and Others* [2013] ZAGPPHC 271 para 128.

²³⁴ Bahl & Bird (2018) 208.

²³⁵ Freire & Garzon (2014) 173.

wages of employees) and capital inputs, such as physical assets both fixed and movable, which is subject to depreciation.²³⁶

5.4.4 Exceptions and tax relief measures

It would have been ideal to tax all businesses, however for administrative purposes and to promote SMMEs it is recommended that the LBT must exempt businesses that fall below the VAT turnover threshold.²³⁷ Since the LBT is likely to have an adverse impact on employment and investment, it is recommended that a job creation and capital investment incentive system must be built into the tax. Contrary to the job creation incentive used in Hungary which affords businesses a rebate based on the number of jobs created during a particular fiscal year, such a tax incentive system will promote labour inputs over other inputs, such as capital inputs. To prevent the over-allocation of resources to labour, it is proposed that the tax incentive system must reward business equally for its job creation and investment. A firm's credit or taxable rebate may be calculated by multiplying a predetermined rate to the annual amount spent by businesses on each input.

5.4.5 Setting of rate

Following international best practices, it is suggested that to ensure political accountability metros should be able to vary and set the tax rate within a predetermined range as determined by the Minister of Finance.²³⁸

5.4.6 Calculation

The tax base may be calculated in two ways, namely: subtractive method - total sales revenue minus total purchases from other firms, excluding VAT or in terms of the additive method (expenditure incurred on factors of production may be added together). The subtraction method would be the preferred method since firms are not required to obtain any additional information such as invoices to determine their tax liability.

5.4.7 Administration

The production-based LBT could easily be administered by SARS on the annual returns submitted by businesses. To avoid administrative duplication, it is suggested

²³⁶ Section 5(1)(e)(i) MFPFA.

²³⁷ Section 5(1)(e)(iv) MFPFA.

²³⁸ Section 5(1)(e)(ii) MFPFA.

that the Minister must appoint SARS as the tax-collecting agent.²³⁹ This is necessary to prevent the inadequacies associated with the RSC levies from repeating itself.²⁴⁰ For instance, unlike the RSC levies which was a self-declared tax, SARS is best placed to verify the returns assessment against information presently used for VAT and income tax purposes. Following the correspondence principle for a good local tax, the LBT will not only be payable within headquarter cities such as in the case of the RSC levies but it will be collected across the country. For the sake of administrative simplicity, there is nothing preventing a headquarter city from collecting the tax, however to prevent tax exportation the revenue derived from the LBT must be distributed to non-metropolitan municipalities in proportion to its tax base.

In order for SARS to administer the LBT, the following additional information must be provided to apportion the tax between municipalities:

- a) Distribution of salaries and wages from normal work location, per city; and
- b) Location of physical assets (value per city).

The additional information may be inserted in the IT 14 form which businesses must submit for income tax purposes. This information would allow SARS to apportion and distribute the proceeds of the LBT based on the location's physical assets and the normal work location of employees.

5.4.8 Compliance: s 229 of Constitution

Once the total purchases have been subtracted from the annual sales revenue, the base of the LBT will in essence be the value added by a business. However, as argued in Chapter 4, a LBT on production differs from the traditional consumption-based VAT, sales and income tax in several ways. First, unlike the consumption based-VAT which is levied on a destination basis, the LBT is levied on an origin basis, insofar as the LBT taxes exports and not imports, thus clearly falling on business activities. In other words, while most taxes are eventually included in the purchase price or in some way borne by consumers, the production-based LBT is not explicitly passed on to consumers like the VAT or sales tax. Second, in contrast to the traditional VAT which is assessed in terms of the invoice credit method, the LBT will be assessed on the

²³⁹ Section 5(1)(f)(i) MFPFA.

²⁴⁰ See Chapter 3.

annual returns of a business. Last, the taxable amount of the LBT is assessed on the annual gross receipts of a business, rather than its net-income which is required for corporate income tax purposes.

5.5 Measuring: LBT

As will be recalled from Chapter 2, economists over the years have developed a set of norms to measure whether or not a local tax is good. While these norms are not necessarily a legal criterion, this paper has shown that there is a strong nexus between these norms and the appropriateness requirement envisaged in section 229(1) of the Constitution. Below in table form is an assessment of how the recommended model would score against the norms of a good local tax.

Table 2: Evaluation of LBT against norms of good local tax.

	Criteria	Assessment
1	Revenue adequacy, elastic and buoyancy	Yes.
2	Correspondence	Fairly satisfactory, provided that the taxes paid to headquarter cities are distributed to non-metropolitan municipalities in proportion to their tax bases.
3	Administrative feasibility	Reasonably feasible.
4	Local accountability	Fairly strong, provided metros have the ability to set and vary tax rate.
5	Limiting fiscal disparities	No, likely to perpetuate fiscal disparities.
6	Equity	The tax is likely to be inequitable, because it disregards the ability of businesses to pay.
7	Political acceptability	Highly acceptable because the LBT will realise a national economic policy, job creation and attract investment.

Although the assessment in Table 2 is subjective, one may conclude that both the eThekweni and recommended model is inter alia fairly elastic, buoyant, has minimal distortion, is administratively feasible and is a politically-acceptable tax.²⁴¹ Furthermore, as a tax which is collected across the country, the impact of tax burden

²⁴¹ FFC (2012) 9.

exportation and the allocation of resources in the economy is mitigated, to the extent that non-metropolitan municipalities will be entitled to the revenue yield in proportion to their tax bases. This is consistent with the correspondence principle which prescribes that tax payers should bear the tax burden in accordance with the benefits which they receive.²⁴² Even if the tax is administered by SARS, experience has shown that political accountability may still be achieved if metros are able to determine the tax rate and spend the revenue yield.²⁴³

5.6 Key shortcomings

Despite scoring well on the aforementioned factors, the proposed LBT model is not immune from inadequacies.²⁴⁴ This should not come as a surprise, because practice has shown that it is almost impossible for a local tax to fully satisfy these norms.²⁴⁵ Like most business taxes, the assignment of a LBT to metros will perpetuate fiscal disparities between localities by giving more to those who have strong tax bases. Aside from accentuating fiscal disparities, the tax is likely to be regressive, meaning that it applies to firms irrespective of their economic status or ability to pay.

5.7 Mitigating deficiencies

The first structural flaw of the proposed LBT relating to the perpetuation of fiscal disparities between localities may be mitigated through the design of an appropriate system of intergovernmental transfers.²⁴⁶ Instead of withholding the tax from metros as a means to reduce fiscal disparities, it is argued that the national government must revise the equitable share allocation by transferring more funds to non-metropolitan municipalities in accordance with their fiscal capacity.²⁴⁷ Although the tax is likely to be regressive, equity considerations should be judged on the benefit principle, rather than the ability-to-pay principle, since the proposed LBT envisaged here should be viewed as a broad-based benefit tax.²⁴⁸

Apart from its structural inadequacies, both labour and capital input components of the LBT, in the absence of proper tax incentives, have the potential to be harmful to labour

²⁴² Biiir & Assiamah (2015) 227.

²⁴³ FFC (2012) 9.

²⁴⁴ FFC (2012) 7-8.

²⁴⁵ Bahl et al (2003) 76.

²⁴⁶ Bird (2010) 3.

²⁴⁷ Section 214(2)(e) Constitution.

²⁴⁸ FFC (2012) 11.

and capital if implemented.²⁴⁹ While the tax is likely to affect economic activity and in so doing depress economic growth, thus harming the economy in the short-term, it is contended that this impact may be reversed if the revenue yield from the LBT is put to productive use. Productive use in this context means that the revenue yield must not be used to finance recurring costs but fund infrastructure and services that would create new economic and social development opportunities.²⁵⁰ As a means to mitigate the impact on employment and capital, it is proposed that the LBT must afford businesses a rebate for their job creation initiatives and capital investment for a particular financial year.

5.8 Conclusion

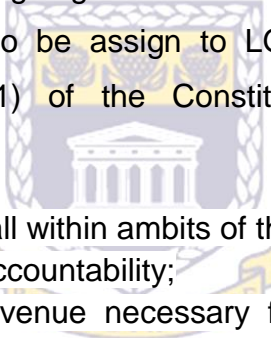
The proposed production-based LBT, the 'Business Value Added Tax' is a common revenue instrument levied in a number of developed countries. Although the model envisaged here is structured in the same manner as the eThekweni business footprint model, the proposed LBT scores fairly well against the appropriateness criteria. Both modalities in principle cannot be faulted architecturally, however in its implementation, the recommended model would have a less adverse impact on labour and capital. This is partially due to the job creation and capital investment incentive built into the tax. While it is not the direct duty of municipalities to create jobs there is nothing preventing a local tax from realising a national economic policy. The exemption of SMMEs from the tax burden coupled with rebates means that the metros will yield less revenue from the tax. However, with the expansion of the local economy, municipalities will be able to make-up the shortfall from existing revenue instruments.

²⁴⁹ Section 229(2)(a) Constitution.

²⁵⁰ FFC (2012) 5.

CHAPTER 6: General conclusion

South Africa's metropolitan cities, despite being engines for economic growth, are faced with tough fiscal choices ahead as growth in municipal revenue slows and the demand for services increases. For cities to realise its full economic growth potential and discharge its cardinal function, that is rendering sustainable services to citizens and businesses, it is indispensable to reduce the infamous fiscal gap. This will require multiple forms of interventions, such as improving revenue collection, expenditure efficiency and increasing transfers to cities. In the current fiscal constrained environment, increasing transfers to cities will be unsustainable. Thus, consistent with international practice which suggests that the most accountable and responsive LGs are those who raise their own revenue, this paper contends that the ideal way to reduce the fiscal gap is by assigning additional own revenue sources to metros. However, for a municipal tax to be assign to LG or a category, the purposive interpretation of section 229(1) of the Constitution prescribes the following requirements:

- 
- a) permissibility (must not fall within ambits of the proscribed taxes);
 - b) tax must promote local accountability;
 - c) must yield adequate revenue necessary for the sustainable provision of services;
 - d) must serve a social and economic development goal;
 - e) must not perpetuate fiscal disparities;
 - f) tax base must be immobile (should not have inter-jurisdictional affect); and
 - g) easy to administer.

The recommended local business tax model was previously rejected by the Minister not because of its illegality, but rather due to the adverse economic environment. The Minister rejected the tax on the grounds that metros must first maximise their current own revenue sources before a new municipal tax may be assigned. As confirmed by various studies, even if metros collected all the revenues due to them from their existing revenue sources, the fiscal gap would persist. Alternatively, a closer analysis of section 229 of the Constitution and section 5 of the MFPFA reveals that the aforementioned factor, which the Minister based his decision upon, should not have been taken into account. On the whole, the real question is not whether the Constitution allows municipalities to impose a BVT-type local business tax, but rather whether the economic environment is favourable.

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