Ladies and Gentlemen:

It gives me great pleasure to welcome you to this topical conference and to share with you some of the more pertinent lessons of the South African tax reform experience.

In discussing the ongoing massive tax reform agenda of South Africa, one needs to structure somewhat this extensive technical topic as there is the risk of getting lost in the detail. Firstly, I intend to focus on the role taxes have played in the Government’s successful fiscal stabilization programme. Here I will primarily concentrate on the progress we have made in reducing the deficit before borrowing and the declining public sector borrowing requirement.

Then I would like to identify two prominent phases of tax reform. Firstly, I need to highlight the huge contributions of the Katz Commission’s policy review and its implementation period from 1994 to 1999. This overview will be followed by a discussion of the post-2000 tax reform phase, which is characterized by a rapid improvement of administrative capacity in the South African Revenue Service and the implementation of two massive structural adjustments to this country’s income tax system. This period coincides with a quantum leap in tax policy analysis and design capacity in the National Treasury. Thereafter I will briefly discuss the adjustments to the indirect tax system, which were less dramatic as South Africa was on track as far as this is concerned – the country introduced in 1991 a standard rate VAT system and an internationally competitive excise tax regime.

1. POLITICAL BACKGROUND

The central challenge facing the Government that took office in April 1994 was to build a modern, vibrant economy that could assume its rightful place in the global economic community, while addressing the massive backlogs in access to vital social and economic services, which was manifest in the extreme inequality of income and wealth.
The policy priorities during this period focused on restructuring government expenditure towards social services that would contribute to a better life for all South Africans and putting in place a macroeconomic framework conducive to investment and economic growth. Given the constraints facing Government, remarkable success in respect of sustainable macro-economic and fiscal balances has been achieved in this relatively short time period.

Clearly, the new Government had to strategically maximise the revenue-raising instruments at its disposal in order to address the huge backlogs in social and infrastructure service provision to the previously disadvantaged communities. The relevance of effective tax collection for South Africa as key to civilization is eloquently summed up in the statement of Franklin D Roosevelt –

“Taxes, after all, are the dues that we pay for the privileges of membership in an organized society”.

2. PERIOD OF FISCAL STABILISATION

The extensive programme of prudent fiscal management and budget reform have succeeded in creating a sound fiscal position and macroeconomic stability. We are now able to comfortably support an expansionary fiscal stance as set out in the 2002 Budget, which is characterized by strong expenditure growth and continued tax relief in the face of adverse global conditions.

Here are some of the big fiscal achievements since 1994:

?? The deficit before borrowing was systematically reduced from 4,5 per cent of GDP to an estimated 2,2 per cent for 2003/04.
?? Fiscal prudence has provided scope for declining debt service costs, to a present 4,1 per cent of GDP, declining further in the 2003 MTEF period. This allows for higher levels of spending without the imposition of a higher tax burden.
?? Stabilisation of the tax burden at approximately 25 per cent of GDP.
?? A decline in government consumption expenditure as a percentage of GDP, from 20 per cent in the mid-1990s to 18 per cent in 2001.
?? A sharp decline in general government dissavings from 4,7 per cent of GDP in 1997 to 0,5 per cent in 2001.

3. FIRST PERIOD OF TAX REFORM, 1994 TO 1999

Let me briefly review the important work of the Katz Commission and some of the key tax reform initiatives that were introduced between 1994 and 1999. The Commission was announced on 22 June 1994. The mandate given to the Katz Commission was very broad. It was to investigate virtually every aspect of the South African tax regime inherited from the previous government against the backdrop of
the political, social and economic goals of the incumbent government. These includes aspects such as:

- Personal income tax with special reference to the gender issue, the tax base, tax thresholds, income brackets, tax rates, progressivity and fiscal drag.
- The impact of the tax system on the position of small and medium enterprises.
- VAT with special reference to the advisability and effectiveness of zero-rating or exemption of certain foodstuffs and other goods and services, and multiple differential rates of VAT.
- Tax exemption for charitable, religious and educational institutions.

Between its inception in 1994 and 1999, the Katz Commission had issued nine interim reports, providing a solid foundation on which to build subsequent tax reform efforts.

4. IMPLEMENTATION OF KATZ COMMISSION’S RECOMMENDATIONS, 1994 – 1999

Looking back to this period of intense tax review, it is in fact remarkable how many of the Commission’s recommendations have been implemented over a relatively short period of time. The tax reform initiatives introduced can be viewed under two broad themes:

- Firstly, there were wide-ranging institutional changes made to ensure the tax laws were administered effectively.
- Secondly, there were policy changes to the tax regime.

Institutional reforms

The ability of Government to design and implement a tax system hinges on the capacity of the Revenue authorities to administer the taxes. Any shortcomings in the administration of tax legislation and the collection of revenue will impinge on the integrity of the tax system and any reform programme.

The first steps in the reform of the tax administration took place on 18 October 1995 when Cabinet approved the restructuring of the Inland Revenue and Customs and Excise Directorates in the Department of Finance (now the National Treasury) into an autonomous revenue collection agency, known as the South African Revenue Service (SARS). These changes put SARS in a strong position to obtain its key objectives of collecting all national taxes, duties and levies, by attracting and retaining competent people, utilising modern information technology and adopting efficiency-enhancing organisational structures and incentive schemes.

SARS has introduced many specific measures to improve the efficiency of tax collection and taxpayer mores in South Africa, thereby reducing the tax gap. Within the organisation, initiatives to improve staff quality and commitment have included introducing new organisational structures and human resource management.
practices. SARS has also increased its capacity to audit, investigate and prosecute suspected tax offenders.

I can state here emphatically today that the Commission’s recommendation on an autonomous SARS will be remembered as the Commission’s most visionary contribution to the fiscal stabilization effort.

**Personal income tax**

While the period 1994 – 1999 can best be characterised as a period of fiscal and macroeconomic consolidation, there were certain tax policy changes and policy announcements that provide reference points for future reform in the post 2000 tax reform era. During the first tax reform period significant advances were made in implementing reforms that improved the personal income tax, the corporate tax (including the secondary tax on companies), the tax on retirement funds and the various indirect taxes.

The personal income tax raises still the bulk of tax revenue – approximately 42.6 percent in 1999/00 and after the huge personal income tax relief of the 2002 Budget this ratio has declined to 35.8 per cent in 2002. It is therefore clear that any policy changes to this revenue instrument will exert profound influences on the overall tax system.

Income tax relief for the period 1994-2002 was close to R50 billion. The number of brackets have been reduced from ten to six; the child rebate was removed to reduce fraud, but the primary rebate was increased annually. Moreover, there were continuous efforts to compensate for inflation by adjusting the tax brackets and the tax thresholds.

Real tax relief has been provided to low- and medium-income taxpayers. The tax treatment of many fringe benefits has also been reformed to ensure more consistent treatment between cash remuneration and non-cash compensation. Despite these changes, the structure of the income tax brackets, the marginal rates applied and the rebate system ensures that the present income tax system is very progressive.

**Company taxes**

In 1999 company taxes, excluding the secondary tax on companies and taxation of mining companies, contribute about 10 per cent of total tax revenue. This has increased to 16.8 per cent in 2001/02.

It is imperative that the tax regime is supportive of private investment. The most important tax changes in the past five years have attempted to create a tax environment that is internationally competitive, encourages investment and fosters economic growth. Two of the most important reform measures introduced, was –
Firstly, a reduction of the rate of secondary tax on companies in 1996 from 25 per cent to 12,5 per cent; and
Secondly, a reduction in the standard corporate tax rate to 30 percent (from 35 percent) in 1999. These changes have reduced the combined tax rate (for non-mining companies) to 38.7 percent from 48 per cent that it was before 1996. These changes are consistent with Government’s approach to encouraging investment through a low standard rate of corporate tax, rather than selective tax incentives, which erode the tax base, distort investment choices and compromise the equity of the tax system.

5. POST - 2000 ACCELERATION OF INCOME TAX REFORMS

Since 2000 the National Treasury stepped up the pace of fundamental income tax reforms with the distinct purpose of aggressively broadening the tax base, thereby affording significant rate reduction in line with international trends. We were able to advance this agenda more boldly through the introduction of technically complex tax provisions because the SARS had enhanced its skills base materially.

In this connection one can identify a three-pronged base-broadening strategy.

First Tax Base Broadening Initiative – Introduction of Capital Gains Tax (CGT)

As stated above, Government has been strongly committed to broadening the base in order to lower overall rates. This broadening of the tax base could only be achieved through major tax reforms. The most notable of these structural reforms was the introduction of the Capital Gains Tax in 2001.

The Capital Gains Tax was essential for the base broadening effort because the exemption for capital gains essentially meant that the appreciation on all investment assets went wholly untaxed. While some argue that the receipts of the tax in and of itself are small, proponents of such arguments fail to recognise that the Capital Gains Tax serves as a backstop to the Income Tax. Tax planners have previously been engaged in the artificial re-characterisation of ordinary revenue into capital gains for far too long. Thus, taxation of capital gains ultimately puts the floor under receipts from ordinary revenue. The two broad principles on which Capital Gains Tax are based are:

(i) Fairness and economic efficiency
Capital profits are economic profits just like ordinary revenue. Both represent a full accretion to net wealth. In other words, taxpayers should bear similar tax burdens regardless of the form of wealth creation. Investors who earn share gains should be subject to tax to the same extent as salaried employees earning wages. CGT also is important as a matter of perception as international evidence suggests that capital gains most often arise in the hands of the wealthy.
(ii) International competitiveness

The introduction of CGT was fully consistent with international practice. Most OECD countries tax capital gains in full (as ordinary revenue) or in part. Many developing countries employ a CGT regime, including Brazil, Chile, Malaysia, and Thailand to name a few. While some opponents of CGT have argued that “there is a trend away from CGT internationally,” full research indicates that no such trend exists.

Government was also careful to ensure that the CGT regime introduced was fully competitive internationally. Corporate rates are set at 15 per cent (only half the ordinary rate), and individual rates are on a graduated scale to a maximum of 10 per cent (only one-fourth of the individual ordinary rate). Individuals also receive a R10 000 annual exemption (plus a R50 000 exemption on death). Lastly, the CGT regime introduced contains many of the exemptions found internationally, such as the primary residence exemption, exemptions for transfers between spouses, and exemption for involuntary disposals.

Second Tax Base Broadening Initiative – Taxation of Worldwide Income

Prior to 1994, South Africa was isolated internationally mirrored by its tax regime. A strict regime of Exchange Controls existed, affording South Africans little opportunity to invest abroad. As a result, South Africa only needed to tax income arising within its geographical boundaries.

In 2001, South Africa began taxing its residents on a worldwide basis. South African individuals and companies are now taxed on foreign source income as a general matter. This taxation of foreign source income reflects the new reality – that South African businesses are becoming global players with the relaxation of Exchange Controls. Taxation of foreign source income fully reflects international experience.

South African individuals and companies are subject to the full weight of South African taxation; otherwise, these individuals and companies would have an artificial incentive to operate abroad. This artificial incentive to invest abroad creates balance of payments concerns as well as equity concerns. Similarly, it could provide opportunities for tax avoidance, such as the “round-tripping” schemes formerly used by certain financial institutions. Under these schemes, taxpayers would obtain an artificial deduction by shifting funds offshore to a special purpose vehicle, only to bring back those funds onshore tax-free.

Income arising from South African owned foreign subsidiaries are now also within the South African tax net. However, taxation of foreign subsidiary income represents a more complex balancing act. On the one hand, the tax system cannot wholly ignore such subsidiaries because South African individuals and companies could simply avoid worldwide taxation by investment through wholly owned foreign
subsidiaries. On the other hand, full taxation of South African owned foreign subsidiaries raises competitiveness concerns. South African owned foreign subsidiaries cannot be expected to compete if subject to a higher taxes than their locally owned rivals.

In order to balance these concerns – and this is important - taxation of South African owned foreign subsidiaries follows a balanced course – again reflecting international best practice. Under this balance—

- **Passive income** (e.g., interest and dividends) as well as diversionary income (i.e., income diverted offshore through various avoidance schemes) are fully subject to tax as that income is earned by a South African owned foreign subsidiary. However, these forms of income can be repatriated back to South African free of tax.
- **Active business income** (e.g., income from sales, manufacturing) is exempt from tax when that income is earned by a South African owned foreign subsidiary. However, that income is fully subject to tax upon repatriation.

### Third Tax Base Broadening Thrust – Simplifying Individual Tax Returns

?? The last mechanism for achieving a broader tax base was the removal of tax schemes commonly employed by individuals. The use of “tax free” fringe benefits to structure remuneration packages had become prevalent in the 1990s, resulting in a substantial loss in revenue. In order to stop this tendency, fringe benefits became taxable in full.

Directors of private companies were brought into the PAYE tax collection system because many directors simply operate like any other employee. Since some directors often disguise their salaries through loans, a formula was introduced in order to determine PAYE in respect of their remuneration.

In the current budget, major changes were made with regard to the deduction of expenses for salaried employees because normal salaried employees have few expenses that relate to the production of their employment income. In order to alleviate the administrative burdens for both SARS and the taxpayers with regard to the expenses which were often abused (such as the entertainment allowance), salaried employee deductions became limited to certain widely used categories.

### Company Reorganisations – Tax Relief Measures

Special relief for corporate reorganisations dates back many years. Most notably, a tax-free regime was introduced for unbundlings and rationalisations in 1993 and 1994. Both regimes provided relief from the Secondary Tax on Companies, stamps duties, and other indirect taxes. The purpose of these regimes was to allow companies to flatten their structures, many of which had become convoluted in
order to avoid many of the political problems associated with the pre-1994 political regime.

Government found it necessary to wholly revise the tax system for company reorganisations when enacting CGT because CGT would otherwise become an all-encompassing/cascading tax event. Under this new regime, taxpayers receive comprehensive tax relief (including relief from CGT) whenever embarking on a corporate reorganisation. This tax relief ensures that the South African tax system remains competitive with other international tax systems offering similar relief. Company reorganisations are a vital part of the economy because they promote more efficient business structures.

Aforesaid relief, however, was somewhat limited due to the complexity involved and concerns that company reorganisations could be used for unintended tax avoidance. A case in point is that the initial reorganisation regime did not provide relief for financial institutions due to the ongoing banking review. After extensive review, relief for company reorganisations was expanded as part of the Revenue Laws Amendment Bill, currently pending before Parliament. In terms of greater significance, the exclusion for banks and financial institutions was removed. The banking review revealed that the low effective rate stems largely from other concerns, such as preferred share and lease stripping schemes, and derivatives.

**Shift From Harmful Tax Practices To Internationally Acceptable Investment Incentives**

Since 1994, Government has taken steps to move away from harmful tax practices (whereby a country attracts foreign investment by offering tax holidays and other “ring-fenced” incentives not available to local companies). South Africa instead seeks to incentivise local investment by using more effective and internationally acceptable means.

With the abolition of the harmful tax practices, Government has adopted a more effective and internationally acceptable approach to stimulating the economy. These incentives largely involve accelerated depreciation for qualifying manufacturing assets. These regimes are fully available to local and foreign investors and generally do not require the administratively burdensome process of advanced approval.

First and foremost, an accelerated depreciation allowance was introduced for plant and machinery employed for manufacturing and similar processes. The new regime allows for a 40 per cent deduction up-front with a 20 per cent deduction for the following three years, regardless of the item’s actual useful life.

Traditional infrastructure, such as pipelines, railway-lines and electricity and telecommunication transmission lines, was previously undertaken solely by
Government. Privatisation and the need to attract foreign investment created the need for the following depreciation allowances—

?? A 10 per cent annual depreciation allowance for new oil and gas pipelines
?? A 5 per cent depreciation allowance for railway lines, electricity and telephone transmission lines
?? A 5 per cent depreciation allowance for airport infrastructure (hangers and runways).

Small and medium enterprises have an important role in economic development and employment creation. Government remains committed to a tax reform programme that contributes materially to investment and job creation. Small business development is a key element of Government’s strategy for economic growth. Both in 2000 and 2002, two key concessions have been introduced to encourage the growth of small business enterprises:

?? A graduated corporate tax rate of 15% on the first R150 000 of taxable income for “small qualifying businesses” with a gross income of R 3 million or less; and
?? A 100 per cent accelerated depreciation deduction for plant and machinery employed by “small qualifying businesses” to the extent that plant and machinery was used for manufacturing and similar processes.

Public Benefit Organisations

Public Benefit Organisations (PBOs) play a vital role in poverty eradication as well as social and economic development for our country. In 2000, Government began a long-term process for achieving a more coherent tax environment for PBOs.

Government has since released a long list of public benefit activities that are eligible for exemption as well as a separate list for PBOs eligible to receive tax deductible donations. The current list of public benefit activities eligible for exemption was widely accepted by the PBO sector as a first step towards assisting PBOs in becoming financially sustainable. No doubt exists that further work will continue in this area, especially in regard to extending the list of PBO’s eligible for receiving tax deductible donations.

6. INDIRECT TAX REFORMS SINCE 1994:

Value-added tax

The Value-added Tax (VAT) was introduced in 1991 to replace the General Sales Tax and at a standard rate of 14 per cent. The VAT is levied on a very broad base. Certain education and health services, financial services, and services of non-
governmental organisations were also exempt. Furthermore, certain commodities consumed mainly by low-income households were “zero-rated”.

In 1996, pursuant to the Katz Commission recommendations, the definition of the VAT base was extended to include all fee-based financial services, except for premiums on life policies, contributions to pension, provident, retirement annuity and medical aid funds.

Excise taxes

Excise duties are levied either on a specific basis (i.e. as a fixed amount on units of a commodity consumed) or on an *ad valorem* basis (i.e. as a percentage of the value of a product’s selling price). Specific excise duties are applied in respect of tobacco, alcoholic and non-alcoholic beverages and the fuel levy. *Ad valorem* excises are imposed on so-called “luxury goods”.

In 1996, a policy decision was taken that excise duties and VAT on tobacco products should jointly impose a 50 per cent tax burden of the retail price of the commodity. Since then, subsequent excise duty increases have ensured that this policy decision has been implemented consistently.

In South Africa increases in excise rates are, however, limited by the incentive for smuggling that would be created if South Africa’s excise rates diverge too much from those imposed in neighbouring countries. Excise taxes on alcoholic beverages are levied on the alcohol content of the beverage, with high-alcohol products being taxed relatively more heavily than low-alcohol products. The excise duty on soft drinks was abolished in February 2002.

7. **CONCLUDING COMMENTS**

During the first term of Government, the focus was primarily on putting in place a policy framework that would contribute to the overall objectives of fostering economic growth in the medium and long term, while at the same time addressing the backlogs in access to basic public services. In this context, the focus was understandably on establishing a sound macroeconomic environment and reprioritising government expenditure toward providing public services contributing to a meaningful improvement in the lives of all South Africans.

The Government appointed the Katz Commission in 1994 to review various aspects of the tax system. The Commission faced the difficult task of recommending immediate reforms that should be introduced in the 1995 Budget, while establishing a framework for medium and long-term tax reform. Recommendations reforming the administrative machinery dominated the early work of the Commission and was an important consideration throughout the Commission’s reports. The first interim
report also set out the guiding principles of tax reform that should underpin all proposals to restructure the tax regime.

Over the total tax reform period of 1994 to 2002, many changes have been implemented. Consequently, structural base-broadening reforms were introduced and subsequent revenue buoyancy gave Government finally the fiscal space for major tax relief. In addition, strong revenue performance supported other key policy initiatives of Government’s fiscal stabilization programme.

I thank you.