



REPUBLIC OF SOUTH AFRICA

**Seventh Interim Report
of the
Commission of Inquiry
into certain Aspects of the
Tax Structure of South Africa**

*Synthesis of Policy
Recommendations with
regard to Provincial Taxation*

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SEVENTH INTERIM REPORT OF THE COMMISSION OF INQUIRY
INTO CERTAIN ASPECTS OF THE TAX STRUCTURE OF
SOUTH AFRICA

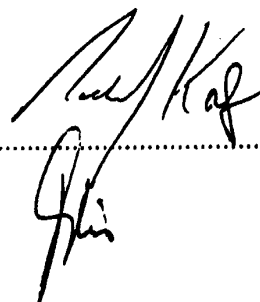
TO THE PRESIDENT

MAY IT PLEASE YOU MR PRESIDENT:

WE HAVE THE HONOUR TO SUBMIT HEREWITH THE SEVENTH INTERIM
REPORT OF THE COMMISSION.

SIGNED AT JOHANNESBURG, THIS 14TH DAY OF JULY 1998.

M M KATZ (CHAIRMAN)

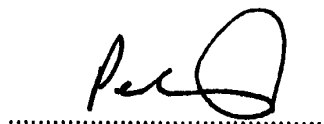


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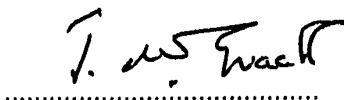
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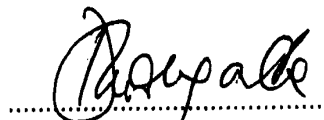
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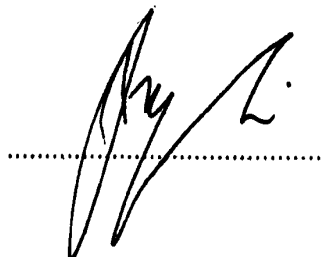
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SYNTHESIS OF POLICY RECOMMENDATIONS WITH REGARD TO PROVINCIAL TAXATION:

1. BACKGROUND

1.1. The Minister of Finance requested the Commission to investigate certain aspects relating to provincial taxation in accordance with terms of reference formulated by the Department of Finance for this purpose.

1.2. It was decided by the Commission to appoint a sub-committee under the guidance of the Commission's Chairman and to review, *inter alia*, the viability of provincial taxes in general and the possible imposition of surcharges on the personal income tax and the fuel levy.

1.3. The sub-committee requested Mr M Grote to prepare a report ("the research report") on the basis of the terms of reference in respect of provincial taxation. The research report also addressed issues not entirely within its terms of reference, but which are of relevance to issues of tax assignment to provincial governments and fiscal federalism in general. In addressing these additional issues it was considered appropriate to do so having regard to the final item in the terms of reference reading as follows:

"Without detracting from any of the aforesaid specific issues, the Commission is required generally to comment on any other relevant matter, be it of a technical, administrative or yield aspect nature."

1.4. The Commission therefore considers the research report to be of great value and a copy thereof will, in due course, be made available to the Ministry, the Department of Finance and the office of the Commissioner for Inland Revenue. The purpose of this report is to summarise the main findings of the investigation pertaining to policy decisions with regard to tax assignment processes. Accordingly, the Commission deals in this report solely with those issues on which the Department of Finance seeks urgent answers.

1.5. The Commission has had the opportunity of reviewing the policy recommendations of the Financial and Fiscal Commission ("FFC") and, in doing so, has taken into account various factors, including administrative feasibility, capacity constraints in the South African Revenue Service ("SARS") and proven accountability standards in provinces.

1.6. In formulating its approach to this matter, the Commission was guided by the requirement to adhere to the following constraining factors, namely:

- (i) the necessity to comply with the Constitution;
- (ii) the imperative of adhering to the Government's policy objective of ensuring that the total tax burden must not exceed 25 per cent of gross domestic product. Accordingly, tax policy suggestions and tax assignment decisions must conform to this objective, which

gives rise to the requirement that nothing must occur in the provincial sphere that could have the consequence of violating this policy imperative;

- (iii) tax policy proposals must, of necessity, take cognisance of capacity constraints that currently exist in SARS;
- (iv) the requirement of preventing the erosion of fiscal discipline. Accordingly, the granting of tax autonomy to the provinces must not result in the violation of this objective; and
- (v) the importance of ensuring that the assignment of taxation powers to the provinces is accompanied by a significant increase in accountability standards.

1.7. The point of departure for any investigation into provincial taxation is naturally an examination of the provisions of the Constitution which deal with this topic. It is entirely inappropriate for the Commission to deviate in any way whatsoever from the principles enshrined in the Constitution. The Commission does, however, respectfully draw attention to the fact that, in its humble opinion, the existing constitutional dispensation with regard to provincial taxation contains certain inadequacies and deficiencies. It is not within the boundaries of the Commission's work to impose its own ideas with regard to the topic of fiscal federalism. Accordingly, the Commission approached its task on the basis of a strict compliance with the existing constitutional dispensation and sought against that background to make certain contributions to the current tax assignment debate in accordance with sound technical tax principles based on information with regard to similar global experiences from which it sought to distill international best practice.

1.8. The Commission points out that at times tax issues falling within the sphere of local, rather than provincial, government were considered and reviewed in considerable detail. This approach is justified by the fact that there exist important funding relationships between central government and the other sub-national spheres of government which simply cannot be ignored, especially in view of the numerous spill-over effects of expenditure programmes.

1.9. Finally by way of introduction, the Commission wishes to place on record its admiration for the thoroughness with which the FFC considered the topic of provincial taxation in its report on that matter. In addition, the Commission wishes to express its gratitude for the courtesy extended to it by the Chairman and members of the FFC in assisting the Commission to deal with the subject matter covered in this report. It certainly has not been the approach of the Commission to endeavour to second guess the FFC or to review the entirety of its recommendations. Only certain issues were dealt with by the Commission with regard to this topic. In particular, the Commission considered whether the provincial surcharge option on personal income tax and the fuel levy are realistic options in the context as recommended by the FFC. One of the most significant aspects addressed by the Commission is whether the proposed surcharge on the rate structure, as a proxy for calculating it on the base as required in terms of the Constitution, is legally competent. Furthermore, the Commission reviewed the question as to whether certain of the recommendations as suggested by the FFC are achievable within the time frame required for devolving tax instruments to the provinces. The Commission does not suggest that its thoughts as expressed in this report are anywhere near to having the status of substitute recommendations for those made by the FFC. Instead, the Commission would prefer the recommendations set out in this report to be considered as qualifications to the recommendations made by the FFC.

2. INCOME TAX SURCHARGE OPTION

2.1. Section 228 of the Constitution sets out the rights of provinces with respect to the imposition of taxes. Section 228(1) provides as follows:

“A provincial legislature may impose –

- (a) taxes, levies and duties other than income tax, value-added tax, general sales tax, rates on property or customs duties; and*
- (b) flat-rate surcharges on the tax bases of any tax, levy or duty that is imposed by national legislation, other than the tax bases of corporate income tax, value-added tax, rates on property or customs duties.”*

2.2. It would appear from the above that surcharges on the personal income tax “base” could potentially be the most important source of provincial own-source revenues. The imposition of a provincial surcharge should occur in such a manner that it does not prejudice national economic policy or lead to “beggar thy neighbour” policies across provinces.

2.3. Accordingly, section 228(2) states that:

“The power of a provincial legislature to impose taxes, levies, duties and surcharges -

- (a) may not be exercised in a way that materially and unreasonably prejudices economic policies, economic activities across provincial boundaries, or the national mobility of goods, services, capital or labour; and*
- (b) must be regulated in terms of an Act of Parliament, which may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.”*

2.4. It would appear from the FFC’s recommendations that the FFC interprets section 228 to the effect that provinces *“...have the constitutional right to impose a flat rate surcharge on the personal income tax (PIT) base. A province does not require authorisation from national government to do so, but it does require national legislation to regulate this activity.”*

2.5. According to the FFC it would, therefore, be preferable for national legislation to be in place prior to 1 January 1998 to ensure that there is a framework for regulating provincial taxation, especially the flat rate surcharge on the PIT base.

2.6. The FFC suggests that the most effective way of collecting a surcharge on a national tax base is through the national tax collection agency, namely SARS. The option of creating or developing a provincial tax collection capacity is strongly opposed. The South African Revenue Service Bill, 1997 dealing with the functional responsibilities of SARS vests in it three functions, one of which is to collect provincial surcharges on the national tax base. Thus, a province which imposed the flat-rate surcharge on the PIT base would expect SARS to collect its revenue on an agency basis.

2.7. The Constitution also ensures that provinces will not be penalised in the revenue-sharing process from the national pool, for any additional revenue they may raise. In this regard it is important to draw attention to section 227(2) of the Constitution which provides as follows:

“Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base.”

2.8. To comply with this section any system of tax capacity (base) equalisation would not permit a deduction from one jurisdiction’s own revenues to subsidise another jurisdiction’s revenues. The tax base

equalisation would have to be developed around adjusting the size of revenue transfers, taking account of relative tax bases.

2.9. A surcharge on the PIT tax base (sometimes referred to as provincial “piggybacking” on a national tax) is to be found in several industrialised countries. However, it has not yet been implemented in any developing country. It would appear that this can be ascribed to the fact that tax administration in developing countries is, for the most part, inadequate. Without detracting from the important efforts SARS is currently undertaking in its restructuring with a view, *inter alia*, to the enhancement of its capacity, it is correct to state that at present SARS is still experiencing problems with regard to its capacity. Accordingly, for the same reason that other developing countries have not burdened their tax administrations by the imposition of a surcharge on the PIT base, the Commission has serious concerns about doing so in South Africa. To do so in the short term could give rise to a risk. This concern is supported by the evidence received from SARS as presented to the Commission.

2.10. Whilst the FFC is opposed to the creation of provincial revenue services, it appears to be confident that tax collection capacity exists at present in SARS for the successful implementation of the surcharge on the PIT base. As stated above, the Commission does not share this confidence over the short term.

Tax room and the surcharge option

2.11. If, despite the concerns expressed by the Commission as to the capacity of SARS to implement the surcharge option over the short term, Government nonetheless decides to pursue such an option, then quite clearly it must be done in a manner which complies with the Constitution. Thus, instead of implementing the surcharge on the basis as recommended by the FFC, the FFC’s recommendations should be amended by the substitution of “abatements” for “rebates” so that the calculation of the base on which the surcharge is imposed accords with the requirements of the Constitution. In this regard it is pointed out that the PIT base can be regarded as taxable income less abatements whereas it cannot be equated to tax due after rebates since the Constitution explicitly refers to base. This has been discussed with the FFC, which agrees with these views. It should be added, however, that this does impose an additional burden on SARS.

2.12. The FFC recommends that the required national legislation be passed as soon as possible to empower provinces “with their constitutionally guaranteed right” to impose surcharges on the individual income tax base. The FFC further proposes that this surcharge be implemented within the context of the national government creating tax room. This would ensure that there is no necessary increase in the overall tax burden with the imposition of the surcharge.

2.13. In essence, what is being suggested here is that the national rates of PIT should be reduced concomitant with the institution of the provincial surcharges. The national rate would be reduced by a nationally determined fixed amount in each tax bracket, before provincial surcharges are imposed.

2.14. The implications of creating tax room can be explained as follows:

- (i) assume that the national average tax rate for PIT is 25 per cent. At the present time all of PIT is collected at the national level;
- (ii) assume further that each province imposes a surcharge of 5 percentage points on the PIT yield (or 5 per cent on the PIT base);
- (iii) if no tax room were created and all provinces imposed the surcharge, the national tax burden for PIT would rise by an average of 5 percentage points;

- (iv) however, if the national government agreed to the creation of tax room equivalent to 5 percentage points, the overall tax burden for PIT would remain the same; and
- (v) twenty percentage points would then accrue at the national level and five to the provinces.

2.15. An important consideration in this regard is the distribution of revenues at the national level and provinces resulting from the creation of tax room. It needs to be remembered that all nationally collected revenue, including PIT, is shared between the national and provincial governments. Moreover, it is pertinent to observe that the creation of tax room of say 5 percentage points at the national level, will not lead to a fall in revenues accruing to the national level unless provinces do not fully occupy the tax room, in which event there will be a fall in revenues. If, however, provinces raise surcharges higher than the reduction in the national rate, then there will in fact be an increase in revenue. The recommendations of the FFC would permit the occurrence of either of these possibilities.

2.16. What in effect occurs, is a redistribution of the share of tax revenue accruing to provinces between that amount being distributed according to a revenue-sharing formula (such as the FFC's inter-provincial grant formula) and that generated by the surcharge. In the absence of a surcharge, all revenue accruing to provinces will be derived from taxes collected nationally and distributed through a revenue-sharing formula, "other" own revenue and loans. When a surcharge is introduced, the total pool of revenue accruing to the provinces as a whole may change. In addition, the revenue available to national government for sharing out under the formula will reduce; an individual province will therefore receive less under the formula and may or may not recoup from the proceeds of its PIT surcharge. Each province in the suggested new dispensation will receive its revenue from an additional (own) source - the surcharge on the PIT base - with the expectation of increased accountability on the part of provincial governments.

The Commission's viewpoint and policy recommendation

2.17. In the first instance, as stated above, it is the Commission's view that the surcharge on PIT as recommended by the FFC contravenes the provisions of section 228(1) of the Constitution in that it effectively constitutes a flat rate surcharge on national tax rates as opposed to the constitutional requirement of the tax base (i.e. taxable income).

2.18. Secondly, as stated above, the Commission has a concern on aspects of administration arising from the FFC recommendation. In order to cure the constitutional violation referred to above, it will be necessary to substitute an abatement system for the rebate system. This does aggravate capacity problems experienced at SARS. As has been stated above, even without effecting adjustments to attain constitutional compliance, the Commission has a concern in the short term about the capacity of SARS to administer the surcharge. It follows that the Commission would have even greater misgivings in this regard since the administration problems are aggravated by the requirement of effecting the aforementioned adjustment.

2.19. Irrespective of the fact that efficiency concerns regarding expenditure assignment measures would be outside the Commission's terms of reference, the Commission still wishes to emphasise that efficiency in spending taxpayers' money is as important as achieving an equitable resource distribution among the provinces. It is further contended by the Commission that the PIT surcharge has conceptually, in the context of South Africa's developmental state, the following drawbacks:

- (i) richer provinces still obtain more revenues out of the system as they will seek to exploit their tax base;
- (ii) consequently, the design of a system of equalising grants to the benefit of poorer provinces will not be obviated by the surcharge option and, hence, one could as well

return to the revenue-sharing option that could have been instituted at the beginning of this tax assignment exercise; and

- (iii) the PIT surcharge would in no way alleviate the position that poorer provinces receive basically a “free lunch” through the system of equalising grants. Scarce national resources could enter the next cycle of misallocation and wasted spending.

2.20. In sum, the preferred choice of the Commission at this point in time would be not to adopt the PIT surcharge option.

Adjustment to the PIT surcharge base

2.21. As set out above, if Government wishes to pursue the PIT surcharge option, then it will be necessary to amend the base to achieve constitutional compliance. In this regard it is pointed out that, in terms of the existing structure of the Income Tax Act, gross income minus exempt income gives rise to income from which special and general deductions and allowances are made to arrive at taxable income on which tax is then assessed. Only at this point is a rebate granted.

2.22. The same effect could be achieved by withdrawing the rebate and by granting an abatement as opposed to the deduction of a rebate at the end of the calculation of the taxable income. Taxable income would then be defined as gross income less exempt income, allowances and abatements. At present rates, an abatement of R16 920 would exactly balance the withdrawal of a primary rebate of R3 215. For taxpayers over 65, a further abatement of R13 130 would balance the secondary rebate of R2 500.

2.23. With the elimination of rebates, a flat surcharge on taxable income will yield exactly the same arithmetical result as a flat surcharge on national tax rates.

2.24. From time to time abatements have been part of our income tax system. Accordingly, no good reason exists for not returning to a system of abatements.

2.25. A possible further option has been suggested during debate in the Commission, namely that after eliminating the constitutional stumbling block in the manner suggested above, there may be advantages to be derived from recommending cautious acceptance of a surcharge on PIT and a portion of the fuel levy to provide provinces with tax revenue. It has further been suggested in this vein that having both the surcharge on PIT and a portion of the fuel levy being implemented would give Government the necessary experience to determine which is the superior of the two options.

2.26. In this regard it is important to note that provincial income taxes were levied until late in the 1960's. Their abolition was recommended by the Franzsen Commission in its First Report (November 1968). The reasons given in support of the Franzsen Commission's recommendations should be taken into account in the formulation of the necessary framework legislation in respect of tax assignment. The material items are as follows:

- (i) provincial budgets should be presented as soon as possible after the national budget so that SITE/PAYE tables can be timeously prepared;
- (ii) the all important residence rules should be kept simple, but the “place of employment” should possibly prevail to determine provincial tax liability for those on the SITE/PAYE system. “Nominated province of choice” offers another alternative, provided residence for at least 90 days in the tax year can be claimed for those on assessment; and
- (iii) where refunds become payable, a *de minimus* rule should be applied, so that small debits to provincial accounts do not clog the system.

Conclusion

2.27. It follows from the foregoing that, in the short term, the Commission has doubts about the advisability of introducing the surcharge on PIT. Even though it has the advantage of being a highly visible tax, it is outweighed by the disadvantage of imposing a burden on the administrative capacity of SARS. It also does not result in accountability in the provinces.

3. SURCHARGE ON THE FUEL LEVY

3.1. A possible alternative to the surcharge on the PIT base is a provincial surcharge on the national fuel levy. This levy could be raised with relative ease at a lower-tier level, provided that retail outlets have pumps with sealed meters that can be monitored effectively. It is equally possible for provincial and/or local government surcharges to be placed upon the national fuel levy. The obvious mobility of motor vehicles will be a check on excessive surcharges. Nevertheless, this option would allow lower-tier governments greater discretion over their revenues than the present system. It is estimated that the fuel levy will contribute approximately R14,4 billion per annum to nationally collected revenues in 1998/99. In this regard it is pointed out that the total annual grant to provinces is approximately R90,4 billion in 1998/99 and provinces' own revenues at present are approximately R4,0 billion. The R14,4 billion would represent 15,9 per cent of total grants. Hence, the imposition of a provincial surcharge within the context of tax room creation could yield substantial revenue to the provinces.

3.2. In addition to the comments and an exposition of the drawbacks and the advantages of the fuel levy surcharge option as set out in the research report, the Commission wishes to highlight the following additional aspects that would be relevant in deciding whether or not to grant provinces some tax room in this regard, namely:

- (i) the problem of administration associated with pitfalls such as the likelihood of cross-border shopping could give rise to escalating policing and compliance costs;
- (ii) furthermore, the incidence of cross-border shopping could give rise to other economic distortions (such as the forced closure of service stations in high levy provinces) that require to be assessed before a final decision can be taken on assigning a certain share of the fuel levy to provincial tiers of government; and
- (iii) the question arises whether the fuel levy surcharge meets with Government's important criteria of enhanced accountability levels in provincial governments as it is unlikely that central government wishes to transfer resources to provinces for which they are not accountable to their respective constituencies.

3.3. The FFC has dismissed the fuel levy by reason of the perceived low yield over the long term. However, the Commission is of the opinion that at present Government requires short-term yield benefits accruing to provinces. Given the overall annual revenue yield of the fuel levy of approximately R14 billion (i.e. if the total fuel levy would be assigned to provinces), the fuel impost would comfortably exceed the revenue yield of the income tax surcharge (the annual yield of say a 1 per cent PIT surcharge would generate approximately R3 billion which means that the total revenue take of the fuel levy would be roughly the same as a 5 per cent PIT surcharge). Hence, over the short term concerns about possible revenue yield inadequacies should not disqualify the fuel levy for assignment purposes.

3.4. From the point of view of administrative capacity on the part of SARS, the Commission is comfortable that the fuel levy can probably be implemented with a minimum of enforcement and compliance costs on the part of SARS.

3.5. Having expressed this confidence in the administrative feasibility of the fuel levy, the Commission does, however, express a major concern of the possible avoidance of the provincial fuel levy surcharge in respect of a particular province by filling up somewhere outside of that province. In evidence presented by provinces to the Commission a view was expressed that taxpayers/motorists will bypass some of the provinces in order to fill up in other low-tax jurisdictions. Thus, even if there is no deliberate distortion, some provinces, due to their disadvantageous geographical location, will not benefit from the ability to individually adjust the surcharge on the fuel levy as they will not attract sufficient traffic. Differently put, in the ordinary flow of commerce certain provinces will get very little yield from the fuel levy and, hence, will again depend on resource transfers from the centre. If a province does not benefit from a levy, its inhabitants can at least benefit from its absence. Obviously a balance will be struck, with lower levies giving rise to higher volumes (and possibly revenues).

3.6. In respect of visibility and the accompanying issue of accountability, net-of-tax pump prices vary because of the different distances from the wholesaler or depots and it would therefore be quite difficult to ascertain accurately the level of fuel tax or the surcharge element in the province's pump price.

3.7. Of all the alternatives considered, the Commission is of the opinion that the most favourable would be the assignment of the fuel levy to the provinces in the medium term. It does not see any short term solution to the problems raised in this Report.

4. ASSIGNMENT CHOICES IN RESPECT OF OTHER TAX INSTRUMENTS

4.1. As set out in the research report, the Commission has reviewed broad policy guidelines with regard to the devolution of certain tax instruments and has indicated which of those instruments, from an economic and tax administration perspective, are more appropriate for fiscal decentralisation purposes. Despite the availability and accessibility of vast and valuable international experiences with fiscal federalism, the Commission was, nevertheless, persuaded during its investigation that there are no easy answers with regard to the most appropriate tax decentralisation model. Although there are some broad international patterns, even fairly homogenous countries at a near identical level of development have indeed adopted very different solutions to the tax decentralisation problem. Hence the surcharge option on the PIT as proposed by the FFC is not necessarily the best solution for South Africa's current situation, although it is often portrayed as the only viable tax decentralisation measure. In fact, the international literature appears to state frequently that the system of piggybacked taxes or surcharges is mostly practised by developed countries and not developing nations. It must also be recalled that it is the specific combination of a country's administrative capacity, historical, political, geographic, cultural and constitutional characteristics that tends to shape the range and synchronisation of feasible and efficacious tax assignment measures.

4.2. The Commission sought, throughout the evaluation of possible options for assigning tax instruments to lower levels of government, to take fully into account concerns with regard to tax administration.

4.3. Furthermore, the Commission has indicated frequently that there are both risks and rewards with regard to tax decentralisation. The mobilisation of additional revenue sources at sub-central level can be more efficient in cases where more relevant or accurate information in respect of the tax base is available at sub-national level. This particular experience informed the Commission's favourable assessment of the land and property taxes, excises on services, gambling and betting taxes and all user charges. The big risks of tax decentralisation are, however, the possible weakening of central government's effective control over tax policy in particular, and also the possible erosion of general fiscal stabilisation policies.

4.4. With these concerns for administrative efficiency and considerations of fiscal prudence in mind, the Commission has briefly set out hereunder its main policy suggestions with regard to the following tax devolution or decentralisation arrangements for taxes not reserved specifically for central government by the Constitution:

User charges

4.5. The Commission, after evaluating all the evidence submitted to it, is of the opinion that the more provinces are able to make use of user charges for their own facilities, the better. This is based on the international best practice for regional governments which is to charge wherever possible and maximise the application of user charges and user fees. User charges are regarded as a beneficial revenue source as they enhance accountability, visibility of the revenue-raising exercise and give rise to healthy competitiveness between provinces. In addition, there would be no need to create tax room and, hence, true user charges would not result in increases or declines in the country's overall tax burden.

Excise taxes on commodities

4.6. After having reviewed the submissions on excise taxes on commodities (for example, excise taxes on alcoholic beverages, tobacco products and soft drinks) and in view of reported international best practice and local experience of inter-jurisdictional tax differentials, the Commission wishes to state that, given the limited geographical size of South Africa's nine provinces, the devolution or imposition of surcharges on excise taxes should be rejected. The policy-making process and collection of excises on alcoholic beverages, tobacco products and *ad valorem* excises should remain an exclusive national fiscal policy function.

Excise taxes on services

4.7. In contrast, excise taxes on services with relatively immobile tax bases such as rates on rural land or tourist taxes appear to be ideal candidates for tax devolution, especially since many local and provincial governments already appear to have considerable experience in this field.

International trade taxes and customs duties

4.8. All international trade taxes and customs duties should remain at national level.

Severance tax or royalties on mineral extraction (*in rem* taxes)

4.9. If the concept of a severance tax or royalty on the extraction or exploitation of non-renewable resources became acceptable in South Africa and could consistently be applied, these imposts could indeed be assigned to sub-national governments. It is important to note that certain Acts have already provided for the imposition of royalties on the exploitation of renewable resources such as fish. The assignment decision is justified by the fact that these taxes or fees are benefit taxes or close approximations of user charges and thus are ideally suited for tax devolution purposes even though they could be collected centrally on an agency basis. The issue regarding a possible introduction of the concept of *in rem* taxes on natural resource extraction is, *inter alia*, the subject matter of the Commission's sub-committee on mining tax and the taxation of mineral rights. Hence, it would be inappropriate to pre-empt the findings and policy recommendations of that sub-committee.

Environmental taxes

4.10. Similarly, the imposition of environmental taxes and the assignment thereof can be justified on the basis of user charges as the "polluter-pays" principle is the very basis of these corrective charges. However, due to the inter-jurisdictional spillover effects of some polluting agents, not all environmental charges or green taxes are suited for devolution and the imposition of market-based instruments seeking to compensate for negative externalities must be decided on a case-by-case basis.

Presumptive taxes

4.11. The presumptive tax idea is new to South Africa, despite the fact that it is being used in many jurisdictions. It is an effective mechanism to tax the hard-to-tax groups, and, based on international best practice, the suggested business license fee as a benefit tax is ideally suited for assignment to provincial governments.

4.12. However, the Commission does not recommend the implementation of a presumptive tax instrument as the suggestion which appeared in this regard in the First Interim Report did not enjoy any measure of support in the country.

4.13. Whether or not the rejection of the presumptive tax as set out in the Commission's First Interim Report was based on any sound intellectual principles, it is nonetheless the view of the Commission that cognisance must be taken of such widespread resistance to the original suggestion.

Betterment taxes or special assessments

4.14. Finally, the suggested betterment taxes or special assessments (i.e. a levy that is imposed on rural property owners who benefit from expenditure programmes that improve rural infrastructure) represent yet another form of benefit taxation and appear to be ideally suited to the sub-national government environment, especially since international experience in this instance suggests impressive gains in efficiency by public service providers and enhanced levels of accountability by public sector officials. The Commission is of the opinion that this model may not be functional in South Africa and may, for example, lead to the overall deterioration of the regional governments' physical infrastructure as people may regard these expenses to be of a lower priority.

5. TAX ROOM

5.1. In principle, the Commission advises against the idea of giving up tax room. It is from this perspective that it advises against the total devolution of the fuel levy, but again there must be a maximum rate level or capping provision in national framework legislation in order to maintain some control on the overall tax burden ratio. Moreover, the Commission is of the opinion that, by giving up tax room without a commensurate cut-back in central government's functional responsibilities, central government will run the risk of remaining with a significant share of the functional responsibilities in the area of concurrent functions. Needless to say, this will translate into the continuation of direct and growing expenditure outlays for central government and increased fiscal imbalances (i.e. growing national fiscal deficits) as national government has lost important revenue instruments. By assigning the full fuel levy to provinces in lieu of only a certain share of the fuel levy, the risk of fiscal imbalance becomes even greater.

5.2. It is important to draw attention to the dangers of tax devolution without a commensurate clear devolution of functional responsibility to provinces. In this regard the following passages from the research report are relevant:

“9.3.1. International experience with fiscal decentralization systems suggests that decentralizing fiscal revenues before a clear delineation of expenditure functions or competency could pose serious risks for the intergovernmental fiscal regime and national fiscal and macro-economic management. Strategies that transfer unchecked general-purpose revenues to sub-national government structures and then seek to negotiate as to precisely what the sub-national jurisdictions are required to do with the revenue and the expenditure programmes for which they should become responsible, tend to introduce more uncertainty, instability and risk into the national macro-economic policy environment.

9.3.2. Many jurisdictions apply undue haste when fiscal decentralization is introduced, thereby designing a fiscal framework without having due regard to capacity constraints in national and sub-national administrations. This has brought many central government fiscal policy makers to the conclusion that decentralization can become an administrative and macro-economic stumbling block, undermining central governments' ability to advance fiscal structural adjustment programmes. Pursuant to this overriding comment on decentralization, other important lessons emerged in Latin America which establish the view that the design of appropriate national framework legislation constitutes one of the most important mechanisms against repeating similar mistakes."

5.3. It is the Commission's view that tax assignment will, in essence, not succeed in addressing an inherently flawed system of unequal revenue potential spread across the nine provinces.

6. TAX SHARING MODEL

6.1. The Commission did not consider in detail the merits of the tax-sharing model as analysed in Chapter 8 of the research report. It is relevant to point out that, for the purposes of the research report, and thus to this report, the term "tax sharing" means an arrangement where the central tax administration is a collection agent of revenues for all sub-national jurisdictions and allocates some of these revenues on a formula or percentage share basis to lower level governments. It usually is an arrangement in which central government retains total control over the major tax instruments (for example, income tax, corporate tax, value-added tax) and levies these taxes at a uniform rate and standardised or harmonised tax base definition. The respective revenues arising from the aforementioned main tax instruments are transferred to states/provinces and local government on a percentage share basis, as negotiated between national and sub-national governments. It is therefore a more decentralised tax system than revenue sharing.

7. NATIONAL FRAMEWORK LEGISLATION

7.1. In view of the above policy suggestions and recommendations, the Commission added to the items that need to be formulated in national framework legislation. The following additional issues, over and above those contained in the research report, need to be addressed in national framework legislation if the fuel levy assignment were to be accepted:

- (i) inter-jurisdictional competition to attract customers, motorists, the trucking industry and business in general to a province will obviate the need to determine maximum and minimum fuel levy rates [at least that is the opinion of the Commission];
- (ii) based on international experience, it would, however, appear to be more prudent to state a minimum and a maximum fuel levy tax rate in order to ensure that provinces will use at least some of the tax potential of a fuel tax;
- (iii) illuminating paraffin ("IP") should be excluded, but reference should be made in this regard to policing problems with regard to the tax evasion measure in the form of blending IP and diesel which currently costs the fiscus approximately R0,5 billion in revenues foregone;
- (iv) the definition of what constitutes fuel or petrol should be consistent with the Brussels International Nomenclature;
- (v) tax should be levied at point of final retail sale; and

- (vi) national framework legislation should not prescribe the overall rate structure, but there should be a ceiling on the overall fuel tax. The Commission is of the opinion that it would fall outside the scope of its terms of reference to determine the rate level but the levy should, however, for valuation purposes, be based on the landed costs.

7.2. Having regard to numerous concerns regarding capacity constraints, including those at SARS, the Commission wishes to emphasize that it is not in the national interest for the national framework legislation relating to tax devolution to be prepared with undue haste. Instead, it would be preferable that the country should gradually manage transformation into a system of tax devolution. In this regard, for example, the imposition of a land tax may be a first step. However, the Commission does not wish, in this report, to preempt the recommendations which will appear in the Ninth Interim Report dealing with land tax, which is at an advanced stage of preparation. There are also other suggestions which are set out in greater detail in the research report, which can be used as interim steps in the incremental revenue assignment process. These include non-tax revenues, such as user charges and fees, that can be devolved immediately.

7.3. The contention is sometimes advanced that tax devolution prompts sub-national structures towards more fiscally responsible conduct and accountability. It is, however, important to bear in mind that a contrary view is that accountability begins on the expenditure side. On the basis of this latter view, the necessity to implement tax devolution in haste is diminished.

8. THE WAY FORWARD

8.1. As set out above, the research report prepared by Mr M Grote is currently being edited. As soon as the editing has been completed, the research report will be made available by the Commission to the Minister of Finance, the Department of Finance and the Office of the Commissioner for Inland Revenue. One of the important purposes of making the research report available as aforesaid is that it contains, in the view of the Commission, very useful background material regarding international comparative studies which will be of benefit to interested parties.

8.2. It remains to express the Commission's great thanks to Mr M Grote for his monumental contribution to the work of the Commission in general and, in particular, to its deliberations on issues of provincial taxation.
