South Africa
Local Government Financial Reform Project

Final Report

10 September 2001

Task 3: The Regional Services Council Levy: Evaluation and Reform Options

RTI Contract No. LAG-I-00-99-00009-00
RTI Task Order No. LAG-I-807-99-00009-00
RTI Project No. 07470-807

SA LOCAL GOVERNMENT FINANCIAL REFORM PROJECT:
Task 3: The Regional Services Council Levy: Evaluation and Reform Options

The Regional Services Council Levy: Evaluation and Reform Options

Final Report

10 September 2001

Prepared by Roy Bahl and David Solomon

Table of Contents

Executive Summary v
1 Introduction 1
2 What is a "Good" Local Tax? 1
3 Administration of the RSC Levy 3
3.1 Identification 3
3.2 Record Keeping 4
3.3 Assessment 5
3.4 Collection 6
3.5 Audit and Penalty 7
4 Evaluation of RSC Levy 8
4.1 Revenue Performance 8
4.2 Revenue Importance 9
4.3 Vertical Equity 10
4.4 Horizontal Equity 10
4.5 Neutrality 11
4.6 Administration Costs 11
4.7 Fiscal Disparities 13
4.8 Benefits and Burdens 14
4.9 Political Feasibility 18
4.10 Legal Implications 19
5 Options for Reform 19
5.1 Decentralized Solutions 19
5.2 Centralized Solutions 19
5.3 Compromise Solution 19
5.4 Option #1: Leave It as It Is 19
5.5 Option #2: Convert the RSC Levy to a True Local Government Tax 20
5.6 Option #3: Turn the Administration of the RSC Levy Over to SARS 21
5.7 Option #4: Abolish the RSC Levy and Adopt a Payroll Tax 23
5.8 General Issue: Should SARS Absorb RSC Administration? 25
5.9 Overarching Issue: The Need for a Local Business License 26
5.10 Option #5: Abolish RSC and Adopt a VAT-Based Grant 27
5.11 Replace the RSC with a Compensating Grant 28
5.12 Replace the RSC Levy with a Mixed Grant-Payroll Tax System 29
6 Conclusion 32
7 References 34
Annex A An Examination of the Relative Levy Bases of District Councils in South Africa 36
Annex B Other Local Government Revenue Options 40

List of Tables

Table 1: Revenue Performance of the RSC Levy 9
Table 2: RSC Levy Revenue Performance in Metros: 1997-1998..... 9
Table 3: OLS Regression Results for Per Capita RSC Levy Revenues..... 13
Table 4: Estimated Exporting/Importing of Turnover Tax and Payroll Tax (in millions)... 16
Table 5: Patterns for Districts That Are Net Exporters and Net Importers of the Turnover Tax..... 17
Table 6: Payroll Tax Rates Necessary to Eliminate Turnover Tax Component of RSC Levy..... 24

THE REGIONAL SERVICES COUNCIL LEVY: EVALUATION AND REFORM OPTIONS*

10 September 2001

EXECUTIVE SUMMARY

The RSC levy is a revenue productive tax that supports the finances of metro and district councils in South Africa. It is levied at a flat rate on the gross sales and payrolls of businesses. The turnover tax component accounts for about two-thirds of revenue. The base is set by the central government, and rates have been frozen since 1996.

Legal strictures have so flawed the assessment and collection of the RSC levy that it is doubtful that it actually taxes either gross sales or payrolls. It operates rather more like a donation by businesses to the local government.

Local governments may neither issue an assessment nor examine the books of a company thought to be under-reporting tax liability. It may not penalize an outright delinquent, nor may it call a non-payer for an examination of accounts. Businesses simply declare and pay what they think is "right", and that is the end of the story. The SARS collector may issue an assessment on behalf of the local government, or may examine the books of account, or may pass information regularly to the district councils, but this apparently is not a common practice.

The RSC levy is fast becoming an urban government tax. The six metros account for about 55 percent of all collections. Big urban governments rely heavily on the RSC (Johannesburg, 18 percent, Cape Town, 33 percent). For the smaller urban districts and the rural districts, it is not as revenue productive, but it is usually the dominant revenue source, often accounting for as much as 90 percent of all collections. The revenue income-elasticity of the RSC in 1999 was about equivalent to that of the VAT and the income tax.

The RSC levy fails most of the maxims for a "good tax". In fact, its main claim to fame seems to be that it is levied at such a low rate that its flaws do not have much impact. The pyramiding that characterizes the turnover tax distorts final market prices and favors vertically integrated firms, while the payroll tax offers a disincentive to employment in a labor-surplus economy. Neither component picks up the informal sector very well, and so another source of horizontal inequity is introduced.

If one considers only the cost of the administrative apparatus required to collect the present tax, the collection cost is a modest 2 percent of revenues received. If one considers the costs of the present collection system to include those taxes that are legally due but not paid, collection costs are quite large.

The RSC levy accentuates the significant disparities in fiscal capacity across districts. Per capita collections range from over 1000 rand to less than 10 rand. The richer provinces do

* The authors are, respectively, Dean and Professor of Economics at the Andrew Young School at Georgia State University, and Professor of Business Economics at Witswatersrand University.

much better than the poor. On average, a ten percent higher level of *per capita* GGP (gross product) is associated with an 8.9 percent higher level of per capita collections.

Businesses pay their turnover taxes at their headquarters location. Those metro and district councils with large concentrations of headquarters firms can export their taxes to other places. We estimate that the six metros collect 57 percent of all turnover tax revenues but that their residents are only burdened with 48 percent of this tax. Residents in non-metro districts pay about 9 percent of the taxes accruing to metro local governments.

There are many reasonable options for reform. The right choice of a reform depends on what goals the government most wants to achieve. In particular, the issue is whether the government wants to emphasize fiscal decentralization, i.e., to make local governments accountable by giving them a hard budget constraint and taxing powers.

If fiscal decentralization is an important objective, then a piggyback payroll tax may well be the best option. This would be revenue productive, more fair, and would support the particular needs of urban local governments. Though SARS would not like the idea of complicating its income tax return (central collection would be a feature of this proposal), a piggyback local payroll tax would be administratively feasible. Local governments would be able to choose the rate within limits, giving a fiscal decentralization feature to the reform. The disadvantages are that the tax on labor in a labor surplus economy might be problematic, and the rural districts would not fare well under such a counter-equalizing program.

A second viable option, also a decentralization strategy; is a combination payroll tax and grant. The former would go to the urban local governments, and would operate as described above. The latter would fund the rural local governments, and could be distributed as the equitable shares grant. The cost to the central government would be relatively small. Under this asymmetric scheme, local governments would be able to graduate from grant to tax, when certain conditions were met.

If the government were not interested in emphasizing fiscal decentralization, then it could introduce a grant program in replacement of the RSC levy. This grant could be funded from a 1 percent add-on to the VAT rate (raising the overall rate to 15 percent). It could be distributed on a derivation basis, but this would be counter-equalizing and would beg the issue of how one decided which district was entitled to VAT. Or, it could be distributed on a formula basis, in which case the issue arises as to how one will finance urban governments. Either way, local councils would have no say in rate or base decisions.

In recommending a decision about the future of the RSC levy, one is torn between being pragmatic and advising on good policy. The easiest political course is to "leave it alone". The issue is not so much that there are great virtues to the RSC levy, but that any replacement proposal will bring on a new and unwanted debate. Despite these arguments for "leaving it alone", the RSC levy is in fact a very bad tax and a poor choice for a revenue source to support South African decentralization. It is more a donation than a local tax, and at any rate other than a very low one, could not be collected. It is regressive, distortive, accentuates fiscal disparities, and provides little fiscal autonomy for local governments. Clearly, it is not a tax to help local governments in South Africa take their place in a decentralized fiscal system. Eventually, it must be abolished or it must be significantly reformed.

An issue arises regarding timing. With so much now going on -- demarcation, municipal structures, property tax reform, and privatization of utilities -- it would not seem optimal to introduce immediately a new, major change to local government finances. One view might be to get through the next year while planning the transition of the RSC to something better, and working out the detailed implementation detail of the new program.

Underlying all of this is the essential issue of the match between the revenue raising powers to be given to the district councils, and their expenditure responsibilities. One should always begin the fiscal decentralization policy planning with the expenditure side. In this case, the first question to be answered is "how much revenue do the district councils need to finance the services assigned to them?" Until this question is asked, and answered, the issue of how much money should be raised by the RSC levy, and where the money should go, cannot be resolved.

1 INTRODUCTION

South African local governments rely heavily on revenues from the regional service council (RSC) levies. The RSC levy is not one, but two taxes: a flat rate payroll tax and a flat rate turnover tax. This levy allows local governments to tap into the broad revenue bases of payroll and gross receipts, and to generate a significant revenue flow. But the RSC levy has a legal basis that makes it almost impossible to properly administer, and as a result it fails when measured against most of the criteria for a "good" local tax. There have been numerous calls for its review and reform (Katz, 1995; FFC, 1995; Permanent Finance Liaison Committee, 1996; Bahl and Smoke, 1998; Franzsen, de Lange and Calitz, 2000).

In this paper, we evaluate the performance of the RSC levy, and we evaluate options for its reform.

2 WHAT IS A "GOOD" LOCAL TAX?

One standard by which to evaluate the RSC levy is the normative criterion for a "good tax" that most economists agree with.[1] To this we might add the criteria for a good local tax,[2] and some South Africa specific issues. The following list is a statement of these criteria.

- The amount of revenue generated by the tax should be *adequate* to cover budgetary needs. There should be a balance between the expenditure needs based on expenditure assignment, and the combined amount of local taxes, user charges and intergovernmental transfers.

- Revenues from a tax should *automatically grow* in proportion to the growth in expenditure needs. If revenues grow more slowly than needs, and if elastic intergovernmental transfers do not make up the difference, local governments will always have to return to voters or to the central government to ask for discretionary increases or look for "gimmicks" to cover their shortfalls. Fiscal gimmicks (extra-budgetary revenues, nuisance licenses or taxes, short term borrowing to cover current expenditures, etc.) are almost always harmful to the economy, and compromise local fiscal discipline.

- Taxes should be *equitable.* Vertical equity means that tax burdens are distributed among individuals at different income levels according to the norms that are acceptable to the country. For example, is the overall national tax system meant to be proportional or progressive, and does the local tax component contribute to that equity goal? Horizontal equity — the condition when equally situated individuals and enterprises are treated the same — is another dimension of fairness in taxation that must be considered. The difficult task here is to define what constitutes "an equally situated" individual or enterprise.

- A good tax will be *administratively feasible.* It should be simple and transparent enough to be understood by voters, and both administration and compliance costs should be

[1] The general criteria for tax reform in developing economies are discussed at length in Bahl (1991), Gillis (1989), and Thirsk (1997). The original canons for a "good tax" were laid out by Adam Smith in *The Wealth of Nations*.

[2] For a discussion on the maxims for local taxation, see McLure (1983), and Bahl and Linn (1994).

"reasonable". The primary villain to be guarded against here is complexity. Local governments and the central government should resist the temptation to try and achieve multiple objectives with local taxes (e.g., equity objectives achieved by deductibility from central income tax, special features to encourage land development or substitution of labor for capital, schemes that use the property tax to promote VAT compliance). Broad-based taxes with flat rates ought to be the general rule. Another problem is that local governments may be given access to an inherently "complex" tax (e.g., a sales tax) but the effective yield is capped at a low level so that the local government cannot adequately recapture the large fixed cost of the collection and assessment infrastructure that it had to put in place.

- Taxes should be *neutral* with respect to market decisions. Violations of neutrality are common. Turnover taxes contain a "tax on tax" element and this cascading leads to higher market prices. Vertically integrated firms are able to avoid this pyramiding of taxes. Payroll taxes bias the choice between capital and labor in favor of the former. Deductibility of property taxes from business income tax liability lowers the tax rate on businesses to below the rate levied on individuals, and may encourage different types of business organization. There are no completely neutral taxes, but it is good practice to stay away from taxes that are known to significantly distort economic decisions. The market should be a much better guide to economic success than is the tax code.

- Finally, taxes must be *politically acceptable.* No one likes taxes, but some taxes are less objectionable to voters than are others. One rule of thumb is that less visible taxes tend to be more acceptable, i.e.; people like the illusion of not knowing how much tax they are actually paying. Taxes collected directly from businesses are examples of this. Taxes paid in small amounts (sales taxes) seem preferable to those paid in large installments or annually, perhaps because the taxpayer is less aware of the total amount of tax paid. Such an approach, however, undermines the goal of transparency. The perception of a revenue-expenditure linkage is considered to be a principal element of insuring that elected officials will be accountable to their constituency. There is also a "certainty" element to political acceptability, because taxpayers like to understand the taxes that they must pay.

To these maxims, we should add some special requirements for a good local government tax.

- There should be a *correspondence* between those who bear the burden of a local government tax, and those who enjoy the benefits of the expenditures financed by the tax. If a local government tax is exported to other jurisdictions, the taxing jurisdiction will have an incentive to overspend because its residents do not pay the full price of services they consume. Moreover, it is unfair for residents of one community to pay for services consumed in another community. A good local tax is one whose burdens fall on the same citizen group that enjoys the services financed by the tax.

- Local taxes should be structured to give the local government a desired degree of *fiscal autonomy.* In a decentralized system, local voters hold elected officials responsible for the quantity and quality of services provided. For this to happen, some minimal conditions must be met. The local government must have some control over tax rates, the tax must be large enough to burden the local population significantly, and it should be visible enough for voters to recognize it as a levy placed on them by their elected local government. All local governments are not capable of accepting the same amount of

autonomy. The percentage of own source revenues in the financing structure will depend on the amount of fiscal autonomy that the central government wants local governments to have. The own-source revenue share of urban governments may be considerably higher than that of rural local governments.

- There is also the issue of fiscal disparities among local governments. To the extent the tax base varies widely among local governments (and it always will, particularly between urban and rural local governments) then there will be concern about how much disparity a local tax will lead to. This is not necessarily a criteria that would lead one to reject a particular local tax, but it does imply (a) that the government must decide how much fiscal disparity it can tolerate, and (b) that there will be need for an equalization transfer program to accommodate those local jurisdictions with weak tax bases.

Even a quick look at this list of norms will convince that no single tax will satisfy all of these criteria. The government is left with a choice among taxes that do some things well and other things less well. The policy decision comes down to which of these maxims the government most wants to emphasize. This is precisely the issue we raise here. Should South Africa live with the significant flaws in the RSC levy in order to capture the benefits that the RSC offers? A broader question is whether the RSC is a revenue source on which the government can base its long run program of fiscal decentralization.

3 ADMINISTRATION OF THE RSC LEVY

To properly understand and evaluate the RSC levy, one must understand its administration. In fact, the assessment and collection of the RSC makes it a very different tax from that which is described in the law. To describe the administration of the RSC levy, we can consider five basic steps in tax administration:

- Identification of the taxpayer
- Record keeping
- Assessment of tax liability
- Collection
- Audit

3.1 Identification

The first step in tax administration is to identify and register the taxpayer, and build a tax roll. The law requires that each enterprise, whether profit making or not, register for the RSC levies.

In theory, there are a number of ways to identify businesses that are liable for RSC levy. The local government could receive data from the central government collector on VAT and income tax registrants; do casual inspections; require joint registration for RSC, property tax and utility services; and make RSC registration a requirement for purchasing a local business license. The first two of these approaches are followed in South Africa, though there likely is great variation across the country and certainly between urban and rural areas. The business license check is not an option because South African local governments do not require a business license. While the property tax and public utility collection procedures are linked,

there is no such relationship between the property tax or public utility charges and the RSC levy.

There is a great deal of variation across the country as regards cooperation with SARS in registering taxpayers for RSC. At one extreme, there appears to be quite a close relationship that works well.

> "A method utilized by some councils with a local office of the receiver of revenue (e.g., Lekoa-Vaal MC in Vereenignig; Sentrale Karoo DC in Beaufort West; Southern DC in Klerksdorp) is quite successful. In collaboration with the local receiver's office, a person can only register a new business with the receiver (i.e., SARS) after he/she has registered as a RSC levy-payer with the applicable DC and has furnished the necessary evidence to the receiver's office." (Franszen, de Lange and Calitz (2000) pg. 25).

In other councils, however, the cooperation between the local finance officers and SARS would appear to give less complete results and other methods must be used. The cases of the urban Cape Town District and less urban Breede River District Council in Worcester are instructive. Cape Town relies heavily on VAT registration and PAYE registration reports received from the central government Collector. However, such reliance on registrations leaves out businesses that fail to register for VAT, including most of the informal sector. Current law places no obligation on firms with less than R50,000 per annum turnover to register for VAT, though it is often in their interest to do so in order to claim VAT credits. If a firm fails to register for VAT, they will be lost to the RSC tax rolls.[3] In CTMC, there were about 33,000 taxpayers in the net in 1994/95. A report by the auditor general estimates that an additional 30 percent of all firms were not in the base. For the most part, these are small firms in the informal sector (Smits, undated). CTMC also uses an informal process of "finding" new firms by an inspection method. This involves "drive-bys," telephone book entries, and casual observation.

The Breede River DC cooperates with the Central Government collector in much the same way. They receive a list of all new VAT registrants and in fact have a reciprocal exchange agreement with the local commissioner for inland revenue. (They also send him the list of any new RSC registrants). Breede River DC also uses "informal methods" to identify potential RSC levy payers. These methods range from studying business advertising (newspapers, signage, telephone book) to drive-by, visual inspection. In some councils, private contractors have been employed on a commission basis to identify potential new taxpayers.

3.2 Record Keeping

It would appear that the tax rolls (however complete or incomplete) are in reasonable shape. In all councils visited in the course of this research, the tax records were computerized and properly kept. Franzsen, de Lange and Calitz (2000) report a similar finding from their field work in district councils.

[3] Presumably, an increase in the VAT threshold to R300,000 would further diminish the RSC base.

There are some issues with record keeping that still need to be resolved. The most important relate to numbering. The RSC levy, the property tax, the VAT and income taxes do not carry the same taxpayer identification number. Moreover, the central, provincial, district and municipal database management systems are not integrated or even compatible. It would not appear possible to perform even elementary database functions, such as crosschecking payment amounts or comparing tax bases. If ever the local governments were to be given authority to administer the RSC tax, then such cross checks would be a necessary tool.

Another problem that arises is that of eliminating firms from the tax roll as they go out of business. This results in unnecessary administrative costs (Franzsen, de Lange and Calitz (2000), pg. 26). The Rustenberg finance office reports that about 8000 business entities are registered for the tax, but only about 5000 are active. About 50 percent of those on the roll owe less than 50 rand. A recent survey by the Cape Town municipal council (Cape Municipal Council, 2000) determined that of 38,000 firms now registered for RSC levy, 2,750 had definitely gone out of business. Another 10,000 had not yet been contacted. Therefore, the number of non-active firms on the roll could be between 7 and 34 percent of those registered.

The registration for RSC levy does not require enough complete data for each firm to support appropriate policy research. It would be desirable for the registration form to have information on, at least, (a) sector of operations, and (b) number of employees. This would allow the government to determine sectors (types of firms) where it should concentrate its collection efforts. Moreover, such information would allow the local government to evaluate the response of RSC levies to changes in local economic structure, recession, etc.

3.3 Assessment

The base of the RSC levy is gross sales, and total payrolls. However, the tax base is self-declared and the local council may not inspect the books of account of a company. Nor is the council entitled to make it's own assessment. In effect, the local government plays no role in determining tax liability. This is arguably the major problem with the RSC levy. In many ways, the RSC levy more closely resembles a donation than it does a tax.
The only good recourse to the assessment dilemma, to request information from SARS[4], apparently meets with only limited success. The response during our field visits suggests something other than a close cooperation.

- In Breede River DC it was reported that the central government collector has been willing to co-operate, though the requests for such cooperation have been limited. In "50 or 60 cases" in the past few years, the collector has used VAT and PAYE returns to compute true tax liability and returned this information to the local government for processing. There are about 5,000 returns in all.

- In Cape Town Metro, underassessment is also seen as a major problem. The financial office recalled how the local government tried, on one occasion, to station a person at the office of the Commissioner to collect information. The Commissioner was, however, reluctant to break confidentiality, or to devote time and resources to the activity. It was never implemented. According to the financial office, CTMC does from time to time

[4] The local government may request the Commissioner of Inland Revenue to evaluate a self-assessment, or to make an assessment.

request the commissioner to supply information to assist in the assessment, but they do not get close cooperation. In some cases, they do receive information from the collector, but it "takes weeks."

- Both the Rustenberg and Brits finance offices noted little cooperation with the collector. In Brits it was reported that they had asked for information, and some was provided in 1997. Since that time, none has been provided. There is no history of cooperation in Rustenberg, and little expectation that there will be cooperation.

The view from SARS (Pretoria) is a bit different.[5] In some ways they see considerable cooperation between the SARS and the district office. It was noted that whenever a PAYE audit was done, the payment of RSC (payroll) levy was "encouraged." However, they also noted that SARS offices had the priority of collecting national taxes: "priorities need to be where the money is."

By law, the local council is not empowered to make assessments. Despite this legal limitation (upheld in the widely-referred-to *Buchner* case), councils do make assessments (Solomon, 1998). However, if the company refuses to pay upon receipt of a summons, and enters a request for appearance in court, the local government has traditionally withdrawn the summons (Franzsen, de Lange and Calitz (2000), pg. 31).

3.4 Collection

The collection process is very informal. Enterprises are "expected" to mail in their returns, or pay in person, and apparently most large firms do this. If a firm does not voluntarily pay, then a "procedure" is followed. Though this procedure likely varies across the country, some DCs mail a bill to delinquents with an inflated tax liability: "50 percent higher than last year," according to one local finance officer visited. As noted above, the law specifically prohibits this, but it is done anyway.
Since true tax liability is not known, it is not possible to estimate a proper collection rate, i.e., the ratio of taxes collected to taxes owed. We do know, however, that the delinquent list is quite large.[6]

A common practice is to use private collectors to collect arrears. Brits Council reported that about 10 percent of its annual revenues come from the collectors. The collectors work independently, and receive a commission of 10 to 20 percent of collections made.

The practice in using collectors seems to vary widely among district councils, as indicated by the following snapshots:

- Breede River District Council uses private tax collectors and pays them a commission equivalent on average to 17.5 percent of what they collect. These collectors are not regulated, nor are they closely monitored. They are essentially free agents who make house calls. Many complaints have been received from the public about the tactics used by collectors, and about their apparent lack of supervision. The Finance Officer also

[5] This reporting is based on personal interviews with SARS officers.
[6] Interestingly, both Rustenberg and Brits Councils report that provincial and local governments are among the largest of the delinquent RSC levy payers.

identified several serious malpractices, such as claiming fees for registering companies that clearly would have complied without help, and claiming for retrieving payments made to the wrong DC (which added nothing to the overall tax collection). Despite such problems, commission collectors do produce significant revenue, according to the Financial Officer. The BRDC has become so reliant on them that it has no regular employees who serve the collection function.

- Cape Town does not use collectors.

- The Brits District Council makes use of private collectors. These collectors bring in an amount equivalent to about 10 percent of revenue, and they are paid a commission of about 15 percent. They work only on the collection of arrears, from a list of non-payers (or suspected under-reporters) supplied by the district council. They also work on registration. The collectors are independent of the finance office, and work directly with the Council. The district collector is "out of the loop" as regards supervision of the collectors.

- The Rustenberg district council uses a private collector. He apparently is quite successful in bringing in additional revenue. He works only on accounts that are in arrears, and operates with little supervision.

- Many other councils use collectors, without complaint or incident, and some councils have introduced "codes of conduct" (Franzsen, de Lange and Calitz (2000), pp. 35-37).

SARS takes a dim view of the use of collectors as not "the right way" to enforce tax compliance. A compliant was that when the SARS receiver turned over evidence to the district, there was a fear that this was being turned over to the collectors. Clearly, this is a violation of the law. SARS reports receiving numerous complaints about collectors. Collectors have "overstepped their powers, and are not properly restrained by the district councils."

3.5 Audit and Penalty

Local governments may not audit the books of a taxpayer, or even challenge the self-assessment. They may pursue non-payers, but there is no penalty for non-payment. The interest rate due on unpaid balances is about 13 percent, which is below the market rate. It is rare for a non-payer to be taken to court. One council reported no follow up at all on undeclared taxes since 1996.

Franzsen, de Lange and Calitz (2000, pg. 38) received questionnaire responses concerning penalties and enforcement from 38 districts, and reached the following stylized conclusions:

1. Some councils have recently refrained from handing over levy-payers who are not paying their RSC levies to attorneys for prosecution. Reasons furnished, include:

- The legal costs involved are too high;

- The amounts claimed are usually based on estimated assessments by the council – which would in all probability not stand up in court (in the light of the *Buchner* case); and

- Private collection agents are successful in collecting these amounts.

2. Some councils do not follow up effectively on non-payment. Lack of capacity and the costs involved are used as excuses. Uncertainty about future municipal boundaries may play a role.

3. Only a few councils indicated that they experienced problems regarding formal appeals in connection with the enforcement of payment of levies (e.g. Amatola DC; Johannesburg MC; Uthukela RC; Highveld DC). Disputes are generally settled outside the courts.

4. The Southern DC in North West utilizes "clearance certificates" to ensure payment from rural property owners. The Registrar of Deeds will not transfer a property to a new owner unless the RSC liability of the seller has been settled.

4 EVALUATION OF RSC LEVY

The RSC levy is really two separate taxes, one on turnover and the other on payrolls. Both are charged against employers. By law, the tax base for both components is quite broad, there are relatively few exemptions and deductions, and the tax threshold is very low. However, as noted above, the administrative practice narrows this base considerably. Originally, the local government, with approval of the Minister of Finance, set the tax rate. Since 1996, however, the rate has been effectively frozen, i.e., no rate increases have been approved. The district council that collects the tax retains all the revenues. The structure suggests that the RSC levy, even if properly administered, would be less a local tax than an intergovernmental transfer that is distributed by origin of collections.

4.1 Revenue Performance

In 1998/1999 the RSC levy yielded R3.1 billion, equivalent to 1.9 percent of total national government tax revenues and 0.4 percent of GDP (Table 1). The income elasticity of the RSC levy over the 1995/1996 – 1998/1999 period was 1.7, i.e., for every 10 percent increase in revenue over that period, RSC revenue increased by 17 percent. However, if we remove the "abnormal" fiscal year of 1997-1998 when RSC revenues increased by 38 percent,[7] the GDP elasticity has been below unity (0.94 in 1999, and 0.42 in 1997). Even so, we might conclude that this is not a weak elasticity for the RSC levies. The GDP elasticity for 1999 for the income tax on individuals was 0.9, and that for the VAT was 0.7. Despite the poor administration, some combination of increased registrations and increased declarations of turnover and payrolls led to a growth that nearly kept pace with income, and did as well as individual income tax and VAT. Given the absence of a threat of audit or penalty this is an amazingly good revenue performance.

[7] Franzsen, de Lange and Calitz (2000, pg. 11) attribute the large increase in 1997/98 to some combination of natural growth and the extension of the tax bases to the (former) TBVC states and self-governing territories.

Table 1:
Revenue Performance of the RSC Levy

Year	Revenue (in billion rand)	Percent Increase	GDP (in billion rand)	Revenue as a Percent of GDP	Income Elasticity
1994/95	1.9				
1995/96	2.0	5.26	497.3	0.40	
1996/97	2.1	5.00	556.2	0.38	0.42
1997/98	2.9	38.10	609.6	0.48	4.05
1998/99	3.1	6.90	654.0	0.47	0.94

Source: Franzsen, de Lange and Calitz (2000) p. 11. Manche, 1996; *Green Paper*, 1997; *Budget Reviews* (1996, 1997, 1998, 1999).

4.2 Revenue Importance

In the urban areas, the RSC levy is of great revenue-raising importance. In Table 2, we describe the revenue importance of the RSC levies in the metros (column 2), as varying from a low of 7.7 percent of total local government revenue in Durban to a high of over 40 percent in Khayalami. A revenue reliance of as large as one-third in Cape Town, for example, means that any reform package must include a suitable alternative source of revenue. To abolish the RSC levy without identifying a replacement revenue source would be an unthinkable intergovernmental policy action.

Table 2:
RSC Levy Revenue Performance in Metros: 1997-1998

	Percent of National RSC Levy Revenue	Percent of Total Local Revenue	Per Capita Amount
Cape Town	12.75	33.3	188
Durban	8.09	7.7	88
Johannesburg	20.96	18.2	228
Khayalami	3.54	41.7	189
Lekoa-Vaal	1.88	NA	84
Pretoria	8.16	14.1	182
National	100.0		145

Source: Columns (1) and (3) from Solomon; Column (2) from Franzsen, de Lange and Calitz (2000) p. 8.

It would be even more unthinkable for the rural districts. Outside the metros, the RSC levy is the only significant revenue source of most District Councils. It often accounts for almost all of total district council revenue (de Lange, 1998, pg. 7). For the country as a whole, RSC is as important a financing source as the equitable shares grant and the conditional capital grants. Again, the story is that the RSC would be a very difficult revenue source to replace.

4.3 Vertical Equity

The two components of the RSC levy are likely to have two very different incidence patterns. The turnover tax is levied on gross receipts with very few exclusions. It accounts for about two-thirds of RSC revenues. This tax is likely to be borne in proportion to consumption and will be regressive in its distribution of burdens.[8] The fact that there are few exclusions (even food items are taxed) and that the threshold of the tax is so low, suggests that the RSC-turnover tax will be more regressive than the VAT in its distribution of tax burdens. However, the administration of the RSC levy might soften this regressivity. The informal sector (where one might expect many low income families work and trade) is largely excluded from the tax rolls. Smit (undated) estimates that about 30 percent of levy payers in the Western Cape in 1994/1995 were not registered, and that most of these were in the informal sector.

The payroll tax component (about one-third of total RSC revenue) will not be as regressive as the turnover tax. Its incidence pattern, however, is not intuitively obvious. Low-income workers in the informal sector will not be in the base because their firms will not likely be registered. High-income individuals who are self-employed also will be outside the base. Finally, non-labor income (e.g., dividends, interests, rents, royalties) is not taxed under a payroll levy, making the RSC less progressive than the income tax.

One might conclude from this that the RSC levy probably adds an element of regressivity to the South African tax structure. However, since it only accounts for about 0.5 percent of GDP, it will not have a significant effect on the overall distribution of tax burdens.[9]

4.4 Horizontal Equity

"Fairness" in taxation requires that people/businesses in the same circumstances be treated the same. The RSC levy does not get bad marks on this count. By law, the tax is very broad-based, and it covers virtually all sales transactions and all wage, salary and fringe benefit payments. In theory, few transactions are exempt and few types of workers are excluded. In many ways, the RSC levy is more horizontally fair than the VAT or the income tax.

There are three areas, however, where the RSC levy introduces horizontal inequities: (a) A worker in the informal sector is not as likely to be subject to the payroll tax as a worker in the formal sector, even if the two earn the same wage. (b) A transaction in the informal sector is not as likely to be taxed, as is an identical transaction in the formal sector. (c) A vertically integrated firm pays less gross receipts tax than does a firm that is not vertically integrated.

There is also the issue of the arbitrariness of assessment and collections. Companies simply pay what they think they should under a system of self-assessment, with little fear of penalty in the event of under-declaration. Some delinquent taxpayers, and some who are deemed to underreport, are singled out for the attention of collectors and likely will end up facing an

[8] For a good discussion of the regressivity of general sales taxes, see Due (1988), chapter 11.

[9] Another equity issue relates to the expenditure of the revenues raised by the RSC. In the district councils the funds are spent primarily in the rural areas to provide essential services. In the urban councils, the revenues are spent for recurrent purposes. Therefore, the expenditure benefits from RSC collections are likely to be spent in a progressive way (at least outside of the metros).

arbitrarily determined effective rate of taxation. The more "savvy" a taxpayer, the lower his burden, and the more honest a taxpayer, the higher her burden. Honesty and knowledge of how to beat the system do not qualify as "reasonable" ways to discriminate among taxpayers. Arbitrariness in assessment usually leads to horizontal inequities in the distribution of tax burdens.

These exceptions notwithstanding, the RSC levy is potentially a broad-based and fair tax. The grounds for reforming the RSC levy probably ought not to include violations of the horizontal equity maxim of a good tax.

4.5 Neutrality

A good tax will not interfere with market-driven choices about business decisions. The RSC levy violates the neutrality rule in two ways.

First, the turnover tax distorts market prices because the tax is pyramided forward at every stage of the production process (Manche, 1996). Because of this, a firm is given an incentive to vertically integrate some of its production and distribution processes. In this way, it may avoid paying the gross receipts tax at some stages of production. There is no available evidence on whether South African firms have integrated to capture this advantage. It is clearly true, however, that a vertically integrated firm, *cet. par.*, pays a lower tax than one that is not vertically integrated.

The other neutrality problem relates to the payroll tax. All other things being the same, an employer will find labor more costly because of this tax, and will have an incentive to substitute capital for labor at the margin. Though we have little information that enables us to predict how firms would react to the tax, an impressionistic view is that this might be a controversial tax strategy in a labor surplus economy. It is true that the RSC tax rate is quite low, but a different view might emerge if one considers the *marginal* impact of the RSC rate in a system that already includes other taxes on labor.

4.6 Administration Costs[10]

A well-administered tax is one that possesses the following characteristics.

1. A high proportion of true tax liability is collected.
2. Administration costs are "reasonable."
3. Compliance costs are "reasonable."
4. There is a minimum of arbitrariness in assessment and collection.

To evaluate the degree to which the South African RSC is well administered, we might consider three hypotheses.

Hypothesis #1: A High Percent of True Tax Liability is Collected. The RSC levy probably fails this test badly. Because there are no data available to the local government on the true amount of taxable payrolls or taxable turnover, it is not possible to estimate how much of the

[10] For a good discussion of the relationship between tax policy and tax administration, see Bird (1992), pp. 183-214.

tax goes uncollected. However, given that there is a low probability of being detected, and a very minor penalty if there is detection, it is a reasonable proposition that the percent of true tax liability collected is very small. This would lead us to the conclusion that collection costs are very high.

Hypothesis #2: Administrative Costs are Reasonable. Whether this statement is true or false depends on how one defines "the collection ratio." Under the broadest definition of administration, the *costs* of collection are composed of:

- Leakage from the system (evasion) due to poor administration,
- Skimming by private collectors, and other corruption, and
- The actual cost of the administrative apparatus.

The denominator of the collection ratio is the actual amount collected. We cannot estimate the first two of these "cost of collection" items, but we can imagine than in the case of the RSC levy, they could easily exceed total collections. This would give a collection ratio of more than 100 percent.

A second way to think about the cost of collection is to estimate what it would cost to collect the RSC levy, if it were fully implemented according to legal base and rate, and if a target collection rate were set. We cannot make an estimate of this amount either. However, at the time the RSC levy was adopted, many critics argued that the collection rate would exceed 80 percent of collections and that "legions of bureaucrats" would be required (Smit, undated).

Perhaps the narrowest view of the collection rate is to look only at the amounts paid for the present administrative apparatus, and divide this by the actual amounts collected. Using this method, we come to an estimate of collection cost equivalent to less than 2 percent of collections (Smit (undated), and de Lange (1998)). By this narrowest view, the collection cost is quite modest. In some cases, however, collection costs have been estimated to be as high as 20 percent (Franzsen, de Lange and Calitz (2000), pg. 15).

Hypothesis #3: Compliance Costs are Reasonable. The RSC levy is self-assessed and the taxpayer is not required to show supporting evidence, nor is he/she subject to audit. Some district councils do hire collectors on a fee basis, and firms must contend with them when they try (illegally) to inspect books of accounts or to make assessments. However, because of the absence of enforcement, one would have to conclude that the present RSC levy imposes little compliance cost.

Another way to look at compliance cost is to consider the case that would hold if the tax were to be properly enforced. Clearly the compliance cost would be higher. Both turnover and payroll are already reported for purposes of other taxes, but some adjustments will be required for the RSC because of its broader base. More important, however, is that the RSC would require a reporting by place of employment, and possibly by the place where the transaction took place, and this would impose a greater burden on those who must comply.

Finally, there is the issue of the unsophisticated taxpayers, i.e., those new to the market. Franzsen, de Lange and Calitz (pg. 15) note that " … some councils including homeland areas not taxed before 1996, report that "new" levy-payers (many of whom are not literate) struggle to comply with the provisions of the Acts and Regulations."

Ease of compliance also requires a good taxpayer information and assistance program. Such assistance is not always in place. For example, one financial officer interviewed noted that the district council had produced an informational brochure on the requirement to register and the mechanism for doing so, but that "there were no brochures available at the present time."

4.7 Fiscal Disparities

There are wide disparities across district councils in the yield of the RSC levy. Over half of total collections take place in the six metropolitan areas (Table 2). The *per capita* collection of RSC levies varies from a high of R1848 in Eastern Gauteng to less than R10 in five provinces, around a mean level of R145.

What are the determinants of this variation among the districts? Why do some district councils raise more on a *per capita* basis than do others? We might study this question with a regression analysis where *per capita* RSC levy is the dependent variable. The explanatory variables in this analysis are population size, the *per* capita level of output[11] of the district economy, and a dummy variable to reflect metro status. It should be expected that *per capita* collections will be clearly and positively associated with the level of economic activity in the area, the size of the population, and metro status.

The results of this analysis are presented in Table 3. We can explain about 75 percent of the variation in *per capita* RSC levy collections with variations in *per capita* GGP, population size and metro location. On average, a ten percent higher level of *per capita* GGP is associated with an 8.94 percent higher level of *per capita* RSC levy revenue. Even after controlling for the level of *per capita* GGP and population size, we find that metro councils collect about 2 rand more in *per capita* RSC levies than do non-metro councils. We can find no significant, separate relationship between population size and *per capita* RSC levy revenue.

Table 3:
OLS Regression Results for Per Capita RSC Levy Revenues[a]

	Total Revenues	Total Revenues	Turnover Tax Revenue	Payroll Tax Revenue
Constant	3.003	1.854	1.284	0.961
Per Capita GGP	0.894 (9.416)	0.977 (11.780)	1.032 (9.788)	0.889 (11.101)
Population	-0.0806 (0.866)	. . . .	. . . .	
Metro Location	0.620 (2.050)	. . . .	. . . .	. . . .
$\bar{R}^2$	0.757	0.746	0.673	0.722

[a] t-values shown in parenthesis below regression coefficient.

[11] There are no available, annual measures of value added by district. We have chosen to use "gross geographic product," which is an *index* of the total amount of remuneration paid to all factors of production. This is the only measure of district level output that is available. See Annex A for a discussion of the "reasonableness" of this measure as an indicator of fiscal capacity.

Differences in the association between *per capita* GGP and *per capita* collections for the turnover and payroll tax components are described in the remaining three columns of Table 3. The level of *per capita* turnover tax collections is more responsive to higher levels of output (measured by per capita GGP) than is the payroll tax.

What we may take away from this analysis is that the RSC levy significantly accentuates fiscal disparities between rich and poor provinces. Councils in metro areas, and councils with higher levels of income, will raise more RSC revenue on a per capita basis, even if they do not levy a higher rate of tax.[12]

4.8 Benefits and Burdens

Following the correspondence principle for a good local tax, we can say that those who pay the RSC levy should be, more or less, the ones who enjoy the services financed by the levy. This "correspondence" principle guards against residents overspending on government services because they are able to export the burden of their tax.

Especially the turnover component of the RSC levy raises the correspondence issue. Though there is some arbitrariness in the determination of where tax liability should rest, it seems generally agreed that the revenue belongs to the jurisdiction where the tax is paid (as opposed to the jurisdiction where the transaction takes place). So, if headquarters of companies generally make the RSC levy payment, then the tax benefit accrues to the headquarters cities, even though the burden of the tax is borne countrywide according to the location of the consumption. Since the collecting jurisdiction is exporting part of its tax burden, it has a direct incentive to overspend.

The payroll tax should fare better in this regard. The tax is generally collected by the employer at the place of work and paid to that jurisdiction. Since the benefit and burden areas match, the correspondence problem does not arise.

To make an estimate of the degree of tax exporting, we have carried out the following experiment. The first step is to estimate a "normal" or expected level of the turnover tax base. We do this by assuming that the national average ratio of turnover to GGP (α) is the most reasonable expectation, i.e.,

$$\alpha = \sum\left(\frac{TTBi}{GGPi}\right) \Big/ 48$$

Where
TTB_i = turnover tax base in the ith district.
GGP_i = gross product in the ith district .

There is an implicit assumption here: that the relationship between gross sales in an area and the total remuneration paid to all factors in that area (GGP) should not change as total output in the area rises. If there is a higher-than-expected share, we will attribute this to a

[12] There is no significant relationship between the tax rate (turnover or payroll) and *per capita* GGP.

"headquarters effect" and assume tax exporting. If there is a lower than average share, we will assume extraordinary amounts of consumption are "imported" from other districts.

Second, we may estimate the expected turnover tax base for district i ($ETTB_i$) as

$$ETTB_i = \alpha \, GGP_i .$$

We have estimated the turnover tax base (TTB) for an area as the quotient of turnover tax collections and the nominal tax rate on turnover for that area.

Third, the product of the average nominal rate (r_i) and the expected base will give an estimate of expected RSC revenues from the turnover tax ($ETTR_i$), i.e.,

$$ETTR_i = r_i \, ETTB_i .$$

Subtracting this from actual turnover tax revenues (TTR_i) gives an estimate of net tax importing (NTE_i) i.e.,

$$NTE_i = TTR_i - ETTR_i .$$

If "expected" is less than actual revenue ($NTE_i<0$) then tax burdens are exported to other districts. If "expected" is greater than actual revenue ($NTE_i>0$), then residents of the district are net importers of the tax burden.

The results of applying this model to the turnover tax are presented in the first two columns of Table 4. An example, Cape Town Metro, may help the reading of this table.

1. The index describing the average national ratio of turnover to GGP is 3.48.
2. This gives us an estimate of "estimated turnover tax revenues" of R276 million.
3. Actual turnover tax revenues in Cape Town were R312 million.
4. The excess of R36 million (column 1) is assumed to be exported to the rest of the country. This is equivalent to 11.4 percent of total actual turnover tax collections in Cape Town.

We may use the results in Table 4 to answer some important questions about who pays the RSC (turnover) levy in South Africa. The six metros in South Africa collect 57 percent of all turnover tax revenues. However, their residents are only burdened with 48 percent of this tax and 9 percent is exported to consumers elsewhere in South Africa.

The negative entries in Table 4 reflect tax importing, the positive entries reflect tax exporting. A more general comparison of population size with the percent of turnover taxes estimated is presented in Table 5.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL

Table 4:
Estimated Exporting/Importing of Turnover Tax and Payroll Tax
(in millions)

District	Turnover Tax		Payroll Tax		Total Levy	
	Amount	Percent	Amount	Percent	Amount	Percent
Amatola DC	2.12	6.1	-1.79	-11.9	0.34	0.7
Benede Oranje DC	2.64	76.2	1.57	78.7	4.21	77.1
Bloem Area	-1.06	-4.3	2.54	14.3	1.48	3.5
Bo Karoo DC	-1.63	-61.5	-0.89	-67.6	-2.52	-63.5
Bophirima DC	0.21	8.2	0.18	15.4	0.39	10.5
Breede River DC	0.89	7.1	1.20	20.1	2.10	11.3
Bushveld DC	-4.06	-37.6	0.28	3.9	-3.78	-21.0
Cape Town Metro	35.59	11.4	-4.77	-7.2	30.82	8.2
Central DC	7.99	58.3	5.64	72.3	13.63	63.4
Diamantveld DC	0.36	2.7	0.22	3.3	0.58	2.9
Drakensberg DC	-1.51	-71.6	-0.51	-42.5	-2.02	-61.1
Durban Metro	35.78	21.7	9.06	12.1	44.84	18.7
Eastern DC	-27.47	-320.5	7.76	36.2	-19.71	-65.7
Eastern Free State DC	-3.36	-33.4	-0.28	-4.3	-3.65	-21.9
Eastern Gauteng SC	69.06	34.2	-6.76	-11.2	62.30	23.8
Eastvaal DC	-21.65	-50.2	-14.75	-83.5	-36.40	-59.9
Goldfields DC	-7.95	-43.9	2.37	15.1	-5.58	-16.5
Highveld DC	10.24	18.1	0.34	1.5	10.58	13.2
IIembe DC	-22.62	-496.4	-11.67	-520.1	-34.29	-504.2
Indlovu RC	7.11	20.7	8.58	38.1	15.69	27.6
Johannesburg Metro	96.01	22.1	13.38	7.2	109.39	17.6
Kalahari DC	-0.78	-11.4	-1.27	-48.9	-2.05	-21.6
Kei DC, Wild coast	-13.80	-436.4	-8.26	-441.0	-22.05	-438.1
Klein Karoo DC	-0.26	-8.8	0.12	6.8	-0.14	-3.0
Kyalami Metro	27.70	37.7	8.05	25.5	35.74	34.0
Lekoa-Vaal Metro	5.41	13.5	-1.26	-8.1	4.15	7.5
Lowveld Escarpment DC	2.03	8.1	0.78	6.5	2.81	7.6
Mzinyathi DC	-21.33	-222.2	-9.14	-136.4	-30.46	-186.9
Namaqualand DC	-4.86	-135.7	-2.14	-101.1	-7.01	-122.9
Hantam DC	-1.22	-111.5	-0.29	-59.1	-1.51	-95.3
Northern DC	-3.10	-9.7	-6.77	-61.0	-9.87	-23.0
Northern Freestate DC	3.05	11.9	-4.82	-66.0	-1.77	-5.4
Overberg DC	-0.57	-9.3	-0.13	-3.8	-0.70	-7.4
Pretoria Metro	-4.52	-2.7	-8.25	-11.0	-12.77	-5.3
Rustenburg DC	7.96	39.0	7.23	53.2	15.19	44.7
Sentrale Karoo DC	-1.22	-126.0	-0.43	-64.9	-1.65	-101.3
South Cape DC	5.21	36.0	1.58	24.8	6.79	32.6
Southern DC	-5.25	-17.9	-1.89	-16.8	-7.14	-17.6
Stormberg DC	-1.38	-37.2	-0.08	-3.2	-1.46	-23.5
Ugu DC	-7.65	..	10.48	72.8	2.83	19.7
uThukela DC	1.30	14.6	-0.05	-1.3	1.25	9.8
uThungulu DC	19.54	49.0	6.52	38.6	26.06	45.9
West Coast DC	-2.15	-18.2	-0.64	-9.8	-2.79	-15.3
Western Gauteng	-7.32	-22.9	-0.72	-3.7	-8.04	-15.7
Western Region DC	6.78	8.6	1.85	4.8	8.63	7.3
Wild Coast RSC	-14.60	-1501.8	-3.48	-59.7	-18.08	-266.0

District	Turnover Tax		Payroll Tax		Total Levy	
	Amount	Percent	Amount	Percent	Amount	Percent
Winelands DC	1.95	7.0	0.46	6.4	2.41	6.9
Zululand DC	-1.42	-31.2	-0.82	-36.4	-2.24	-33.0

Table 5:
Patterns for Districts That Are Net Exporters and Net Importers of the Turnover Tax[13]

	Net Exporters	Percent	Net Importers	Percent
Population above 1 million	Anatola	6.1	Kei DC, Wild Cost	-436.3
	Cape Town Metro	11.4	Northern DC	-9.7
	Durban Metro	21.8	Pretoria Metro	-2.7
	Highveld DC	18.0	Wild Coast RSC	-1501.8
	Indlovu RC	20.7		
	Johannesburg Metro	22.0		
	Thungulu DC	49.0		
	Western Region	8.6		
Population between 500,000 and 1 million	Bophirima DC	8.1	Bloem Area	-4.2
	Central DC	58.3	Bushveld DC	-37.5
	Kyalami Metro	37.6	Eastern DC	-320.5
	Lekoa-Vaal Metro	13.5	Eastern Free State DC	-33.3
	Lowveld Escarpment D	8.1	Eastvaal DC	-50.2
	Rustenburg DC	39.0	Goldfields DC	-43.8
	Thukela DC	14.5	Llembe DC	-496.4
			Mzinyathi DC	-222.1
			Southern DC	-17.8
			Stormberg DC	-37.2
			Ugu DC	NA
			Zululand DC	-31.2
Population less than 500,000	Benede Oranje DC	76.1	Bo Karoo DC	-61.5
	Breede River DC	7.0	Drakensberg DC	-71.6
	Diamantveld DC	2.7	Hantam DC	-111.5
	Eastern Gauteng SC	34.2	Kalahari DC	-11.3
	Northern Freestate DC	11.8	Klein Karoo DC	-8.8
	Southern Cape DC	35.9	Namaqualand DC	-135.7
	Winelands DC	6.9	Overberg DC	-9.29
			Sentrale Karoo DC	-126.0
			West Coast DC	-18.2
			Western Gauteng	-22.9

[13] Percent of actual tax exported as shown in parenthesis.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

We have carried out the same analysis[14] for the payroll tax, as shown in columns (3) and (4) of Table 4. As may be seen from these data, much less of the payroll tax is exported. This results because payrolls are more likely to be taxed at place of work than at headquarters. For example, the six metros collected 51 percent of total payroll taxes, and only 2 percent was exported to other districts.

The results for total RSC levies are shown in the last two columns. About 7 percent of the amount collected in metro areas is exported.

4.9 Political Feasibility

There is no great hue and cry to abolish the RSC levy. Most individuals probably do not realize that they are paying the tax. It is collected from employers and passed to individuals in the form of wages, or profits, or rents that are lower than they otherwise would have been, or in the price of the product sold. Moreover, the nominal tax rates are very low, and the tax is not seen as onerous.

In fact, what makes the RSC levy acceptable is its weak administration. If the tax were fully and properly administered, voters might find it objectionable. It would be seen as regressive, exerting a bias against labor, and introducing significant compliance and administrative costs. In fact, because the RSC levy now functions very much like a donation, it is not a source of widespread public discussion. Who would object to a donation that they chose to make? There are, nevertheless, complaints about the RSC and these are objections that would no doubt become louder if a more significant RSC levy were to be proposed.

1. There is fear that the RSC levy administration will be reformed to allow local governments, or SARS, to make full and proper assessment of RSC liability. In this case, many observers would suspect that the courts would be faced with question of the constitutionality of RSC as a sales and/or income tax.

2. Many businesses have objected to the imposition of a tax by district councils, when they, the business community, have no representation on the district council decision-making body (Smit, pg. 24). This is more an emotional than a fair argument, since it is individuals and not businesses that ultimately bear the burden of the tax. But it is a point of political contention.

3. There is a complaint that the benefits of the tax do not reach the taxpayers. Especially in the case of farmers, there is an argument that they do not see any direct gain for the RSC levy in terms of services provided (Franzsen, de Lange and Calitz (2000), pg. 26). For this reason, about 12 districts have provided a "farm rebate".

[14] When we estimated the total payroll tax using this method, the result exceeded the actual collections by a significant amount. Therefore, we assumed the percent of exported payroll taxes were correctly estimated, but we scaled down the total amounts proportionally.

4.10 Legal Implications

The future of the RSC levy depends in part on the Courts. By law, local governments may not levy sales or income taxes. The RSC levy clearly is both. The turnover tax is a general sales tax, and the payroll tax is a tax on labor income. Surprisingly, the use of the RSC levy at the local government level has not been challenged. However, should the tax be levied at a significantly higher rate, it is almost certain to be challenged.

A second legal issue has to do with the rights of the local government to examine the books of account of a company when it deems that tax liability has been under- declared. The position of the court seems very clear on this. The local council may not impose an assessment on a business, nor may it require a business to submit its records for examination. The SARS collector may do both, and may cooperate with the local council in assessment and collection, but this is at the discretion of the collector (and the Minister). The evidence so far, seems to point to less than adequate cooperation between SARS and local councils on the matter of RSC collection.

5 OPTIONS FOR REFORM

There are many choices for reforming the RSC levy, or replacing it. The "right" choice depends on the objectives that the government most wants to achieve with the RSC levy. Perhaps most important, the "right choice" will depend on expenditure assignment, i.e., on the expenditure responsibilities given to the district councils. With this qualification in mind, we may turn to evaluation of what would appear to be at least seven feasible choices:

5.1 Decentralized Solutions

1. Leave it as is.
2. Convert it to a true local tax and make proper provision for administration.
3. Leave the RSC levy structure as it is, but turn the administration over to SARS.
4. Abolish the RSC as it now exists and replace it with a piggyback on the payroll tax.

5.2 Centralized Solutions

5. Abolish it altogether and replace it with a VAT-based grant to local governments.

6. Abolish it altogether and replace it with an *ad hoc* grant.

5.3 Compromise Solution

7. Do some combination of 4 and 6 above.

5.4 Option #1: Leave It as It Is

There are good arguments for not making a major revision in the RSC levy at the present time. Most important, it is revenue productive and will be hard to replace quickly. There are some other features that make it a candidate for survival. It is by now accepted by the public and seems to be generally understood, the administrative and compliance costs are low, and it is a relatively elastic revenue source that has become the primary own revenue source in most

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL

district council budgets. It is problematic in many ways, but its low rates minimize the distortions that it creates. Local governments have precious few productive revenue sources. Why change something that works?

There is another important consideration. The timing for reform may be bad. The decentralization policy and implementation of the boundary commission rulings will shock the system enough. There also are other changes under discussion concerning local government, e.g., property tax reform, the municipal systems bill, and electricity privatization. Why add to it with a major revenue change? If the RSC is to be reformed, let it wait for a year or two when there is less on the local government agenda.

There is also the point that the RSC levy is a local government revenue and to many, is preferred to any centralized solution. The local governments are not likely to trust central solutions, and there could be significant political resistance. There is a widespread feeling that if the central government received the money first, a fair share would not find its way down to local government treasury. National emergencies or new priorities would always be in the wings as significant reasons to divert the funds to central government purposes. The RSC levy in its present form, however imperfect, is a tax whose collections are controlled by the local governments.

Critics of the "leave it as is" approach can make strong substantive arguments in favor of moving ahead with reform. The RSC is badly and unfairly administered. (See the discussion above). It is more in the nature of a contribution by local businesses than it is a tax. The RSC levy is also subject to the complaint that its burden is borne nationwide, but its revenues are more localized in the bigger cities because so much of the tax is paid at the headquarters location. This problem is likely to grow worse. Because it is the nature of a donation, there is no assurance that revenue growth can be maintained. Finally, its major component is a turnover tax, and there is some question about whether a gross receipts levy has a place alongside a VAT in a modern tax system.[15] One could make the case that such an imperfect tax is hardly the right cornerstone for the tax structure of local governments in South Africa. Unless it is reformed, it will remain a kind of donation to local government by local businesses and will remain outside the control of the local councils.

On balance, the basic issue probably is not whether the RSC levy should be reformed, but whether this is the right time to do the reform.

5.5 Option #2: Convert the RSC Levy to a True Local Government Tax

The RSC levy could be converted to a local tax, with local government administration of the tax. The local government would be given authority to set the tax rate within prescribed limits, and would be empowered to assess and collect the tax. There is much to say for this option. First, local governments in South Africa would have a revenue source over which they could exert some control to raise or lower revenues. Elected local councils, who would set the tax rate, would be accountable to voters over how the money was spent. This could

[15] It should be pointed out that subnational government turnover taxes are used. Among other places, it is a major source of revenue in Buenos Aires, and in two U.S. states. However, the criticism of local turnovers taxes is strong everywhere they are used.

lead to improved public services. This option would be consistent with the government's decentralization strategy.

Second, the local council would have an incentive to increase revenues and the power to improve the administration of the RSC levy. As the RSC levy is converted from a donation to a tax, revenues would rise significantly and administration would be significantly improved. More money would be available for infrastructure and for supporting the issuance of long-term bonds. The revenue position of urban local governments would likely be improved most.

This solution also has significant drawbacks. First, giving local governments the option of levying a turnover tax provides the headquarter's district the opportunity to export the burden of the tax to other jurisdictions of the country, i.e., to the place where the purchases take place. This violates the basic correspondence principle of local taxation, and could lead to a situation where rural South Africans are paying for the provision of urban services. A second drawback is that this tax would be costly to administer. A major training and procedural effort would have to be mounted to prepare the local governments for this new responsibility. Assessment and collection of the RSC levy would require training of financial analysts and auditors who would be responsible for verifying assessments, and the installation of a collection system. It would also require a taxpayer information and assistance service. All of this implies a quite significant one-time cost (especially outside the metros), as well as the maintenance of a staff of significant size to operate the RSC levy.

Third, compliance costs would rise. Businesses now self-assess and make payment. Under this proposal, their self-assessment could be challenged and would require supporting evidence. Moreover, non-filers would more likely be pulled into the system and required to comply. Most taxpayers do not like stricter compliance requirements; hence this proposed reform would generate political resistance.

Fourth, major changes in the legal structure of the tax and its administration would be required and this would raise timing, legal and political issues. Significant legal hurdles would have to be overcome. For one, the laws would have to be changed to allow local governments to issue assessments, and to inspect and audit the accounts of businesses. Another important legal change is that significant penalties would have to be adopted as part of the new tax structure, and district governments would need powers to enforce this law. This proposal is likely to face significant opposition from the business community who would anticipate both an increase in taxation and an increase in compliance costs, and from the central government who would see the RSC as a competitor for the indirect tax base in South Africa.

Fifth, the law would have to be amended to allow local governments to collect this tax, which is in effect both an income and sales tax (neither of which are options that are legally open to local governments).

5.6 Option #3: Turn the Administration of the RSC Levy Over to SARS

A third option, often discussed, is that SARS could take over all administration of RSC levy. It could, for fee, act as the collection agent for the local governments. All else (tax rate, tax base, etc.) would remain as it is. Certainly there are advantages to this proposal. Arguably,

the administration to do this is in place, and a costly duplicative local government tax administration could be avoided. In theory, administration would be much improved and therefore more fair. Assessments would be made by the SARS collector on behalf of the district council, and all assessments automatically would be verified against value added returns and income tax returns. This is all provided for in the present law. Taxpayers could submit the tax as part of their VAT or income tax return, thereby minimizing compliance cost. A collection fee of 2 percent would be approximately equal to the administrative costs presently borne by the district councils. The remaining 98 percent would be deposited in the district council account.

Another advantage of this approach is that it would be perfectly consistent with allowing the local governments to set the tax rate, thereby providing a measure of local government fiscal autonomy. Each budget year the district council could vote the RSC levy rate, up to a prescribed ceiling. Neither SARS nor Treasury would have a say in this.[16]

Since there would be penalties and an inspection threat, and since SARS could do regular crosschecks against VAT and income tax records, one would expect a significantly greater revenue yield than under the present system. Would this approach yield more than option #2? One view is that local government will "try harder" because they are collecting their own tax. Another view is the SARS has the more efficient machinery: (a) The payroll and sales records are on file, (b) A more highly trained staff is in place, and (c) All VAT and income tax audits could automatically include an RSC levy audit. The answer to the revenue productivity question probably turns on "How hard will SARS try?"

There are major drawbacks and questions about this approach. First, it leaves the turnover tax component of the RSC levy in place, and so the central government tax administration would be collecting both a turnover tax and a value added tax from each VAT-registered taxpayer. One tax eliminates the pyramiding problem the other embodies it. A fair question to be raised is whether a combination turnover-VAT has too many offsetting features to be a good long run solution for local government finance. Among these, in addition to the pyramiding problem, are (a) incentives for vertical integration, (b) administrative and compliance costs, (c) biases against high turnover enterprises, and (d) taxpayer confusion.

Second, there is the issue that SARS would have little incentive to collect this tax, because they would receive none of the revenue. Even with payment of a "commission" it is doubtful that the incentive would be adequate. Perhaps an even more important issue is whether SARS has the capacity to take on this additional administrative burden, i.e., do they have excess staff capacity or would this take away from the efficiency of their duties as collectors of central government taxes? Would the *marginal cost* of collecting the RSC levy be inconsequential, or would it divert significant time and effort of SARS assessors and collectors away from VAT and income tax?

Another issue that arises is collection from those enterprises with tax liability below the floor level for VAT. Registration and collection from these firms would be administratively

[16] Such piggyback arrangements are widely used in the US. About two-thirds of the state governments tie their income tax base to federal adjusted gross income. Most states have piggyback arrangements with their local governments for both sales and income taxes.

burdensome and possibly not revenue productive. SARS would likely argue that the time of its staff could be better spent increasing the compliance rate for larger firms.

5.7 Option #4: Abolish the RSC Levy and Adopt a Payroll Tax

The RSC levy could be replaced with an equal yield payroll tax. The tax base would be payroll, as under the present RSC. All self-employed and withholding taxpayers would be liable. The local government would choose a tax rate on payrolls, within limits prescribed by the central government. The tax would be collected by the central government, at the same time as the central income and payroll taxes, and then remitted to the district government. A collection fee would be deducted before transfer to the local treasury. The transfer of funds would be clearly prescribed in the law.

There are some very significant advantages to this option. It is a tax where the burden is mostly borne by those who benefit from local services (assuming that the headquarters problem can be minimized by shifting exclusively to a payroll tax). It eliminates the turnover tax. It provides local autonomy, because local governments may choose the tax rate, within limits. It provides for administrative efficiency because the central government collects the tax, and it lowers compliance costs (at least by comparison to most of the other options suggested). SARS will have no disincentive to collect because the base will be identical to its own payroll tax. It would be more progressive than the present RSC levy in terms of the distribution of tax burdens.

There also are drawbacks. Some of these are quite major.

- It is a tax on labor in a labor surplus economy, and another payroll tax has recently been introduced. At the margin, such a tax would discourage employment. The disincentive to employment may be very small, but it will be present.

- It may not be horizontally equitable. It will tax labor income, but for administrative reasons, will likely miss most self-employed income and possibly much of the informal sector. Moreover, it would not include capital income in the base; hence those who earn from rents and dividends would be advantaged.

- It will take up some "tax room" in the central government's self-imposed 25 percent effective tax rate ceiling.

- It will accentuate fiscal disparities because many rural councils will have very little payroll tax base.

- There is the question of the legality of a local payroll tax.

The seriousness of these problems will depend in part on the level of the payroll tax rate chosen. If the nominal rate is low enough, the "employment effect" and the horizontal inequities might be significantly discounted. We have estimated the payroll tax rate that would have been necessary to hold every district council at approximately its 1997/98 level of RSC revenues. These rates are presented in column (2) of Table 6, and the percent increase

Table 6:
Payroll Tax Rates Necessary to Eliminate Turnover Tax Component of RSC Levy

District	Existing Rate	New Rate	Percent Change
Amatola DC	0.3166	1.0553	73.9
Benede Oranje DC	0.3000	0.8231	52.3
Bloem Area	0.3450	0.8267	48.2
Bo Karoo DC	0.3330	1.0069	67.4
Bophirima DC	0.2500	0.7896	54.0
Breede River DC	0.3000	0.9300	63.0
Bushveld DC	0.2850	0.7125	42.8
Cape Town Metro	0.2500	1.4318	118.2
Central DC	0.2500	0.6887	43.9
Diamantveld DC	0.3300	0.9706	64.1
Drakensberg DC	0.3450	0.9509	60.6
Durban Metro	0.3000	0.9581	65.8
Eastern DC	0.2500	0.3500	10.0
Eastern Free State DC	0.3000	0.7582	45.8
Eastern Gauteng SC	0.3740	1.6255	125.2
Eastvaal DC	0.3300	1.1349	80.5
Goldfields DC	0.2500	0.5381	28.8
Highveld DC	0.3400	1.1624	82.2
Ilembe DC	0.3000	0.9091	60.9
Indlovu RC	0.3000	0.7573	45.7
Johannesburg Metro	0.4182	1.3940	97.6
Kalahari DC	0.3000	1.0962	79.6
Kei DC, Wild coast	0.3500	0.9409	59.1
Klein Karoo DC	0.3360	0.8964	56.0
Kyalami Metro	0.3800	1.2667	88.7
Lekoa-Vaal Metro	0.2960	1.0527	75.7
Lowveld Escarpment DC	0.3100	0.9558	64.6
Mzinyathi DC	0.3000	0.7299	43.0
Namaqualand DC	0.3648	0.9822	61.7
Hantam DC	0.3300	1.0645	73.5
Northern DC	0.2850	1.1015	81.6
Northern Freestate DC	0.3135	1.4172	110.4
Overberg DC	0.3470	0.9914	64.4
Pretoria Metro	0.3648	1.1768	81.2
Rustenburg DC	0.2750	0.6875	41.3
Sentrale Karoo DC	0.3400	0.8388	49.9
South Cape DC	0.3200	1.0482	72.8
Southern DC	0.2500	0.9033	65.3
Stormberg DC	0.3100	0.7688	45.9
Ugu DC	0.3000	0.3000	0.0
uThukela DC	0.3000	0.9947	69.5
uThungulu DC	0.3000	1.0063	70.6
West Coast DC	0.3020	0.8508	54.9
Western Gauteng	0.2500	0.6620	41.2

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL

District	Existing Rate	New Rate	Percent Change
Western Region DC	0.3820	1.1553	77.3
Wild Coast RSC	0.3500	0.4084	5.8
Winelands DC	0.2500	1.2324	98.2
Zululand DC	0.3420	1.0364	69.4

over the present rate is shown in column (3). The results suggest that an average effective payroll tax rate of about 1.1 percent would be required to hold RSC levy revenues at present levels. The maximum rate under this scenario would be 1.6 percent (Eastern Gauteng). Local governments would be required to increase their rates by 78 percent on average. Two issues are worth noting here:

a. These rates are calculated against the *existing* payroll tax base for RSC levy. The actual nominal rate would be much less than the estimates shown in Table 6. This is because the base of the payroll tax would be much larger if it were collected by SARS.

b. The overall burden on South African taxpayers would not be higher than it is now under the scenario presented in Table 6. The revenue collected from the new payroll tax would be exactly equal to the revenue that would have been collected from the present RSC levy.

5.8 General Issue: Should SARS Absorb RSC Administration?

Underlying options #3 and #4 is the issue of whether SARS could/would take over administration of the RSC levy. Option #3 would require taking over the RSC in its present form, and option #4 would require administering a piggyback local government payroll tax.

The general view of SARS (based on interviews) appears to be that they would be resistant to any reform that would complicate the administration of national taxes. Clearly, both of these options would complicate the tax administration task for SARS. The collections from every business would have to be assigned to a district council and this would introduce new reporting requirements and some degree of arbitrariness. However, administration of the two components of the RSC levy (turnover and payroll) imposes two very different kinds of burdens on SARS.

Consider first the administration of the turnover tax. SARS has experience with VAT. Collection of a gross receipts tax (while not an optimal policy) from firms already on the roll could be done with a minimum of difficulty. SARS presently requires supporting information on gross sales in order to compute value added tax liability. However, companies report gross sales in a consolidated return, with no identifiers as to where the physical transaction took place. The introduction of a requirement to report every sale according to the district in which it took place would be a significant complication. Moreover, there is an underlying question of which district council *should* be credited with the revenue from a turnover tax collection. For example, a large bank may now do all transactions at headquarters and not at the branch. Should not all of the revenue from a transactions tax be credited to the headquarters office where the transaction was carried out? Such complications will almost certainly lead to notional allocations, and this is not the business of SARS.

A payroll tax, piggyback levy is more feasible. SARS already collects PAYE, UIF and Skills levy. Why not just tack RSC levy on to this? For registered taxpayers, the RSC, UIF and Skills have the same tax base, hence all could be filed on one return. The problem again would be the allocation across districts. For companies doing business in one district, this is no problem. For companies doing business in many districts it would be a problem because SARS does not presently ask for a separate schedule showing a breakdown of employment and payroll tax liability by district. Neither would SARS want to be responsible for working out the allocation.

On the other hand, centralized administration of a payroll tax could be feasible. It could easily be added to the return since the same base as is levied for other payroll taxes would be used. It would require, however, that each firm attach a statement showing the allocation of its payroll tax, by district. While adding some complexity, this would not seem an insurmountable obstacle, and most businesses could handle it quite easily.

An overarching problem is that the SARS organization is not perfectly suitable for collecting local taxes. First, the district offices of SARS do not match up with district council boundaries. Some SARS districts cover multiple district councils, some district councils lie in more than one SARS district, and some metros have more than one SARS district. (This is not necessarily bad for enforcement purposes, but it makes data collection very difficult.) The SARS collection districts are as follows:

- Total number is forty-two.
- Five in Cape Town.
- Eleven in Johannesburg area (40-50 percent of all collections).
- Three in Natal.
- Twenty-three spread across the rest of the country.

There are five regional offices to which these branch offices report, including one each in Natal, Guateng, Mapul, Free State, and Western Cape.

Second, SARS is moving towards a more streamlined system of centralized processing of returns. This would mean a more centralized system of record keeping, and a much greater possibility for electronic transfers. The cabinet has already approved this program, and implementation is planned in the next 18 months. This may not be compatible with the collection needs for a local government tax.

We might summarize this discussion by noting that SARS is headed in a different policy direction than is the government's fiscal decentralization program. The former is concentrating primarily on increasing the compliance rate, simplifying administration, and gaining the efficiencies of administrative simplification. It will likely be a tough sell to get SARS to enthusiastically embrace the notion of administering local taxes, especially local taxes that would introduce complications into the reporting by South African business taxpayers.

5.9 Overarching Issue: The Need for a Local Business License

SARS collection of a payroll tax is more feasible than SARS collection of a turnover tax. However, in neither case is it reasonable to expect SARS to register, assess and collect from

small firms that are below the threshold of existing central government levies. The administrative effort required would be far out of line with the revenues gained. Moreover, when the central government raises the VAT threshold, or de-emphasizes compliance efforts for smaller firms, local government revenue collections will suffer.

Yet, small firms should not be excluded from payment of local government taxes. They are users of local services, and important voting members of the local community. They can be reached with a business license fee, perhaps levied as a flat amount. Every business would be required to register, annually, and display a decal. Compliance checks could be provided by a linkage to property tax or to property transfers. This could produce significant revenue with relatively little administrative cost.

5.10 Option #5: Abolish RSC and Adopt a VAT-Based Grant

A more centralized option would be to abolish the RSC levy and replace it with a grant based on a surcharge on the value added tax. A revenue neutral surcharge on VAT in 1997/1998 would have required an increase in the VAT rate from 14 percent to 14.97 percent. Under a surcharge plan, an amount equivalent to approximately one percent of the value added base would be dedicated to a "local government fund", as a replacement for the RSC levy. The size of this fund would grow in proportion to the growth in the value added tax base, hence the local and the central governments would be tied to the same tax-income elasticity.

The problem would be how to distribute this fund among local governments. Clearly, there is no objective formula that will exactly reproduce the present distribution of RSC levy revenues. There will be "winners" and "losers" with any formula chosen. Countries usually deal with this by introducing "hold-harmless" provisions during the system transition. There would seem to be three methods open for distribution of such a fund:

- The first is derivation. Each district council would be allowed to retain the amount of VAT collected in their jurisdiction that is equivalent to the yield of a 0.97 percent rate.[17] This has the disadvantage of being counter-equalizing, but the advantage of providing a significant base of revenue support for the urban local governments. However, it raises again the headquarters problem since firms will report VAT liability according to headquarters location.

- Second, the grant fund could be distributed by a needs-based formula. One possibility would be the equitable shares formula. This would be equalizing but it would penalize the urban jurisdictions. How would their lost revenues be made up? Another drawback is that this approach could channel significant revenues to local governments that do not have the capacity to spend the funds.

- Third, the government could distribute the grant fund on a more *ad hoc* basis, perhaps in the form of conditional grants. This has the disadvantage of not being consistent with the government's decentralization policy of providing some degree of autonomy to local units of government.

The VAT surcharge-grant does have some appeal as an option.

[17] This is similar to the VAT-Sharing systems in effect in Russia and China.

1. It eliminates the turnover tax, which would be an advantage to the economy.

2. It eliminates the need to determine where a transaction took place or where an employee worked.

3. It gives the local government sector access to a productive and elastic revenue base, i.e.; the grant pool will grow as fast as VAT collections.

4. It should be administratively "better" than the present RSC levy, and would impose no additional compliance cost. The marginal cost of collecting a higher VAT rate is near zero.

5. Because the VAT surcharge would be better administered than the current RSC levy, it can raise X rand with a lower effective rate than was faced by most firms who paid the previous RSC levy.

6. There would be no overall increase in the tax burden on South Africans. The increase in the VAT would be exactly equal to the reduction in the RSC levy.

There also are drawbacks to this option:

1. Since it is a grant instead of a local tax, it will be a step back from local autonomy, and will remove one major revenue source where the local governments had an incentive to stimulate collections.

2. The distribution of this revenue pool could be very contentious if done on a derivation basis, because this will favor the big cities and will keep in place the "headquarters" problem. In fact, VAT collections almost certainly will have to be carried out at the HQ location. But if grant revenues are distributed on a formula basis, for example by the equitable shares formula, then this also will be contentious. Many will argue that local governments in the rural areas will now receive windfall revenue that they are unable to spend properly.

3. The increase in the VAT rate might be argued to take some "taxing room" away from the central government, and seen as competition to central government revenue mobilization efforts.

4. There is also the "flypaper" concern, i.e., the revenue will first land at the central level and it will stick there.

5.11 Replace the RSC with a Compensating Grant

Another possibility would be to abolish the RSC levy and replace it with a compensating grant to local governments. In other words, if the RSC would have yielded X rand in 2001, it would be replaced with a central government grant of X rand in 2001. In each successive year, the size of the grant fund would be determined by the central government. Many countries have introduced such "compensating grants."

One could find some advantages to this approach. It would enable elimination of the turnover tax, and it would resolve the RSC administration problem. Businesses would no longer be burdened with any RSC levy. It would lead to a reduction in administration and compliance costs.

But this proposal would have a great many drawbacks. The notion of "compensating" can be defined in year one, but how about the future? What would the tax have yielded in 2002, 2003, etc? This leaves local governments at the mercy of the center in deciding on the allocation, and all but eliminates transparency in vertical sharing. A second problem is the horizontal distribution. Would the grant fund be distributed as a formula grant? If so, would it be distributed on a counter-equalizing basis in order to hold harmless the larger urban areas that finance local services heavily from the RSC? Finally, this option has the drawback of being a step back from local autonomy and from a long run program of fiscal decentralization. An implication is that the district councils would be completely at the mercy of the central government in terms of revenue, i.e., the districts would no longer have a significant, defined source of revenue. Likewise, the revenue independence of metro governments would be significantly reduced.

5.12 Replace the RSC Levy with a Mixed Grant-Payroll Tax System

Another option is to eliminate the RSC levy but to drop the constraint that it must be replaced with a single instrument. It is widely recognized that urban and rural councils have quite different capacities to tax and to spend. A program where urban areas are given taxing powers and rural areas receive compensating grants is another possibility for replacing the RSC levy. The Ministry of Provincial Affairs and Constitutional Development (undated, pg. 19) raised the question of an urban-rural asymmetry in discussion document for the *White Paper*: "Should a different system of local government be developed for rural areas or should there be a uniform system for urban and rural areas?" One version is the following:

1. Urban areas would be given the power to levy a payroll tax, and could set some specified limit for the tax rate. The central government would collect the tax along with its own payroll taxes and remit the money to the local unit where the collection took place. Urban areas could collect a business tax from the smaller firms.

2. Rural areas would receive a general-purpose grant, and would have no RSC taxing powers. The size of the national grant pool would be fixed at some amount greater than the difference between the present total level of RSC levy revenues and the amount of RSC levy revenue raised by those local governments who would be given the power to tax. The distribution of the national grant fund among local governments would be according to the same formula as equitable shares. The vertical pool would be grown at the same rate as the equitable shares pool.

3. Areas that are urban but not metros would be given the option to join either system. Once a council joined the taxing system, it could not return to the grant system.

A more detailed discussion of how such a system might work is presented in Box 1.

Box 1: How The Mixed System Would Work

Each district council would be assigned to one of two groups: (a) the "tax group", or (b) the "choice group". All metros would automatically join the tax group, and would be authorized to levy a payroll tax in amount up to 2 percent. Collection would be by SARS, with an agreed-on collection fee. The base of the tax would be the same as other government payroll taxes. Each payer would be required to identify payroll tax liability by district.

The "choice group" could elect either the payroll tax or a grant. The grant would be distributed from a fund whose size would be determined by the central government. The distribution among districts would be according to a formula, perhaps the same formula as used for the equitable shares allocation. Presumably, each district would calculate its comparative advantage. The expectation is that the more urban and/or industrialized places would choose the payroll tax.

How much would such a program cost? Consider first the view of the central government. The net "cost" would be the size of the local grant fund. This could be as little as 42 percent of the present level of RSC revenues.[1] To the extent that non-metro councils elect the payroll tax option, the grant fund could be even smaller. So, the cost to the central government could be relatively small, perhaps as low as 0.2 percent of GDP. If the central government opted to increase the grant fund, this would raise the cost to the central government.

The other way to look at "cost" is to ask about the increased burden on South African taxpayers. This is the more relevant issue from a point of view of public policy. The change in Total Burden (ΔTB) will be equal to:

$$\Delta TB = PT + GF - RSC$$

Where PT = payroll tax collections
GF = grant fund revenues
RSC = Regional Service Council Levy revenues

Under one scenario, we could set

$$GF = \beta_\iota RSC$$

With $0 \leq \beta_\iota \leq 1.0$

In which case overall burdens would be rise of fall depending only on the choice of the payroll tax rate by the urban councils.

[1] Metro districts now collect 58 percent of RSC revenues.

There would be significant advantages to this approach.

- The turnover tax would be eliminated, and urban councils would no longer be able to export tax burdens to the rest of the country.
- The problems with local government administration of the RSC levy would no longer be an issue. The payroll tax would be administered by SARS.
- This approach would provide decentralized taxing powers for urban local governments. This would bring more accountability to their elected councils and likely a greater rate of revenue mobilization.
- Urban local governments would have an income-elastic revenue source.

- The payroll tax is less regressive than the present RSC levy, hence there would be some improvement in the distribution of tax burdens.
- Different urban areas would have different tax burdens. This is appropriate because the cost of providing public services varies across urban areas and citizens in high cost places should pay more. The tax cost in urban areas would be greater than the tax cost in rural areas.[18]
- The government would not incur any significant cost in administering this program. The urban areas would levy their own payroll tax. The rural grant program would impose no additional cost.
- The government could control the overall cost of the program. The grant fund could be set at some amount less than the total RSC levy (which would be abolished), hence there would be no real cost. The urban tax (think of it as an urban services charge) would be over and above this and would not place any cost on the central government. The overall change in tax burdens on South Africans would be the difference between what the RSC levy would have yielded, and the sum of the urban services tax and the grant fund.

This program, like any, has some disadvantages that would have to be addressed. The following are the main problems.

- The payroll tax increases the price of labor and may discourage employment.
- The urban local governments will mobilize more resources with the payroll tax, but they also will compete with the central government for tax revenues. The more they raise from the payroll tax, the less discretionary room the center will have to increase its own income taxes.
- The payroll tax is not horizontally neutral in that it will not cover non-wage income and may miss much of the informal sector.
- The collection of the payroll tax by SARS would require each business to allocate its payroll tax by district.
- There is no decentralization for rural local governments in this plan. They would not receive any additional taxing powers. In fact, in future years, the district councils will be at the mercy of the central government in terms of the determination of the vertical share for the grant pool.
- The provisions for graduating from the "grant" group of councils, to the "tax" group, could be complex.

[18] The *overall* local tax burden is already higher in metro areas than in the rest of the country, so this proposal would reinforce a difference that already exists. On average, locally collected revenues in metro councils amount to 13 percent of household income in metros, but only 4 percent in small towns and rural councils (Department of Finance, 1999).

6 CONCLUSION

In recommending a decision about the future of the RSC levy, one is torn between being pragmatic and advising on good policy. The easiest political course is to "leave it alone". The issue is not so much that there are great virtues to the RSC levy, but that any replacement proposal will bring on a new and unwanted debate. The center will not want to give up a significant claim on the national tax base to local governments. Some local government officials are hesitant to take responsibility to impose taxes on their constituency. The RSC levy is a badly flawed tax, but maybe not flawed enough to cause these political obstacles to be put aside.

The great advantages of the RSC levy are that (a) it is a known quantity, (b) it is a major revenue source for district and metro councils, and (c) it is levied at low nominal rates. Perhaps the most telling statement about the RSC levy is that its many shortcomings are forgiven because they are hidden by the low rate at which the tax is levied.

Despite these arguments for "leaving it alone", the RSC levy is in fact a very bad tax and a poor choice for a revenue source to support South African decentralization. It is more a donation than a local tax, and at any rate other than a very low one, could not be collected. It is regressive, distortive, accentuates fiscal disparities, and provides little fiscal autonomy for local governments. Clearly, it is not a tax to help local governments in South Africa take their place in a decentralized fiscal system. Eventually, it must be abolished or it must be significantly reformed.

But, this leaves two questions: (a) When to abolish the tax? (b) How to replace it? On the question of when, the timing is bad at present. Demarcation, a new municipal structures bill, property tax reform, etc., are already many changes for local governments. This might prompt the government to live with the RSC a while longer, until there is less change on the plate of local governments.

On the issue of a replacement revenue instrument, there would seem to be several choices. The "best" option will be determined by what the national government most wants to achieve with its decentralization program. If the goal is a fiscally decentralized system, then two choices stand out for long run reform. One is a local government, piggyback payroll tax. This could be effectively administered, burdens would be borne where benefits were received, it would be revenue productive, and interpersonal equity effects would not be bad.

The other decentralizing choice would be a hybrid system whereby rural local governments would be financed with a grant system and urban local governments would be given new taxing powers. This would give autonomy to urban but not rural districts, and would avoid the problem of asking rural governments with weak fiscal capacity to depend on a local tax.

If fiscal decentralization is not a goal of government, then the best option may be the VAT-based grant. That is, the national government would add a rate on to the VAT and distribute this sur-rate by formula among the local governments. It would be administratively easy, transparent, and could produce significant revenue. It would, however, not give local government officials any ability to control the size of their budgets and would break the accountability link between local officials and the voters.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

Underlying all of this is the essential issue of the match between the revenue raising powers to be given to the district councils, and their expenditure responsibilities. One should always begin the fiscal decentralization policy planning with the expenditure side. In this case, the first question to be answered is "how much revenue do the district councils need to finance the services assigned to them"? Until this question is asked, and answered, the issue of how much money should be raised by the RSC levy, and where the money should go, cannot be resolved.

7 REFERENCES

Bahl, Roy. Editor. 1991. *The Jamaican Tax Reform.* Cambridge: Lincoln Institute.

Bahl, Roy and Johannes Linn. 1994. *Urban Public Finance in Developing Countries.* Baltimore: Johns Hopkins University Press.

Bahl R.W. and Smoke P. 1998. "Municipal Finance Reform and Fiscal Decentralization: Moving Forward." A report prepared for the Department of Constitutional Development (DCD) and United States Agency for International Development (US AID).

Bird, Richard. 1992. *Tax Policy and Economic Development.* Baltimore: John Hopkins University Press.

Budget Review, 1995 - 1999.

Cape Metropolitan Council. 2000. "Unicity Income and Financial Strategy Working Group: RSC Levy Project." August 29.

De Lange, D.J. 1998. "A Framework for Improving Local Payroll and Turnover Taxes in South Africa." Unpublished report for the Department of Constitutional Development.

Department of Finance. 1999. "South African Local Government Finance Review, 1998/1999." Republic of South Africa.

Due, John F. 1988. *Indirect Taxation in Developing Countries* (revised edition). Baltimore: Johns Hopkins University Press.

Financial and Fiscal Commission. 1995. "Framework Document for Intergovernmental Fiscal Relations in South Africa" (First Draft). 19 June 1995.

Financial and Fiscal Commission. 1997. *Local Government in a System of Intergovernmental Fiscal Relations in South Africa: A Discussion Document.* 25 July 1997.

Franzsen RCD, De Lange D and Calitz E (2000) "The Current Status of RSC/JSB Levies levied by District, Regional, Services and Metropolitan Councils in South Africa" Unpublished report for the Department of Finance (sponsored by GTZ).

Green Paper on Local Government. 1997.

Gillis, Malcolm. Editor. 1998. *Tax Reform in Developing Countries.* Durham: Duke University Press.

Katz, MM (Chair). 1995. *Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa.*

Manche, J.B. 1996. "Payroll and Turnover Tax: The Potential of RSC Levies as a Source of Local Government Financing." An FFC working paper.

McLure, Charles. Editor. 1983. *Tax Assignment in Federal Countries.* Canberra: ANU Press.

Ministry of Provincial Affairs and Constitutional Development and the White Paper Political Committee. Undated. *South Africa's Local Government: A Discussion Document*. Republic of South Africa.

Permanent Finance Liaison Committee. 1996. "Existing and Potential New Sources of Revenue for Local Government." March.

Smith, Adam. 1964. (1776) *Wealth of Nations*. New York: Everyman's Press.

Solomon, David. 1998. "Butterworth's Regional Levy Report." August.

Solomon, D. 1985. The Site Value Tax: An Evaluation. *South African Journal of Economics*, vol. 53, no. 3, pp. 248 – 257.

Solomon, D. 1984. *Should Municipalities Redistribute Income? BML*, vol. 13, no. 7, pp. 205-207.

Solomon, D. 1982. *The Principals and Practice of Local Finance in The Western Cape.* UCT. pp. 1-89.

Thirsk, Wayne. Editor. 1997. *Tax Reform in Developing Countries.* Washington, DC: World Bank.

White Paper on Local Government. 1998.

ANNEX A
AN EXAMINATION OF THE RELATIVE LEVY BASES OF DISTRICT COUNCILS IN SOUTH AFRICA

In order to understand the relative size of the levy bases in different DCs, we undertook an analysis of the local District economy. In order to form a picture of local economic activity in the Districts, techniques of cross sectional data analysis were chosen which rely on relative data within a single year, rather than on absolute data, or time series data. There is good reason to believe that the relative values are stable, allowing inferences to be drawn, even from problematic data. The data and analysis presented here offers insights into the relative sizes of the base of various DCs. Care should be taken to avoid drawing inferences from the absolute magnitude of any variable.

There is very little data gathered on the SA economy at local or municipal level. The existence of Gross Geographic Product (GGP) data presents therefore a valuable opportunity to assess the relative sizes of the levy base in each district. The data have many shortcomings: As a time series it is inconsistent, including and excluding areas as they were incorporated into the former homelands. It is out of date, the latest available data being for 1993.

Gross Geographic Product, South Africa

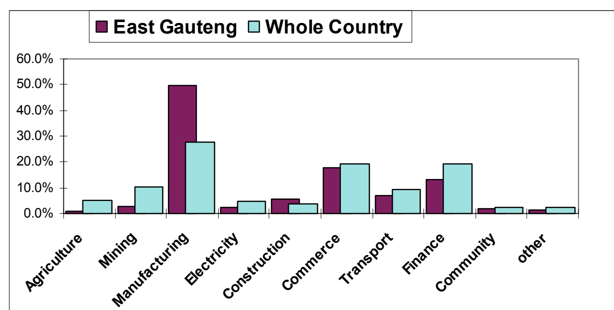
Top 10 Districts by GGP

DC	Total Levies	GGP (1993) Rx1000	Population	GGP per Capita
Johannesburg Metro	621,418,000	58,050,786	2,729,609	21,267
Cape Town Metro	378,000,000	39,713,704	2,753,701	14,422
Pretoria Metro	242,000,000	32,022,607	1,331,827	24,044
Durban Metro	239,958,294	30,900,893	2,726,742	11,333
Eastern Gauteng SC	262,100,000	25,158,028	141,793	177,428
Eastvaal DC	60,770,000	13,783,027	948,591	14,530
Western Region DC	117,747,100	13,617,955	1,437,043	9,476
Western Gauteng	51,331,243	11,282,435	60,173	187,499
Highveld DC	80,000,000	9,515,200	1,195,663	7,958
Northern DC	42,900,000	8,796,438	4,801,681	1,832

This table shows the largest 10 districts, sorted by GGP. Predictably the four large metropolitan governments, Cape Town, Johannesburg, Durban and Pretoria head the list, confirming the conventional wisdom that South Africa is an industrial, urbanized economy. Also unsurprising is the next on the list, East Gauteng.

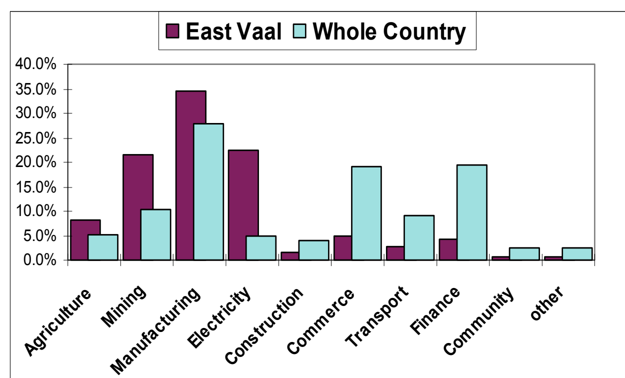
Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa
RTI INTERNATIONAL

The chart alongside illustrates the strong industrial base of this region, which makes up the heavily industrialized outer ring of the Gauteng region. Included here are the industrial towns of Alberton, Benoni, Boksberg, and Germiston.



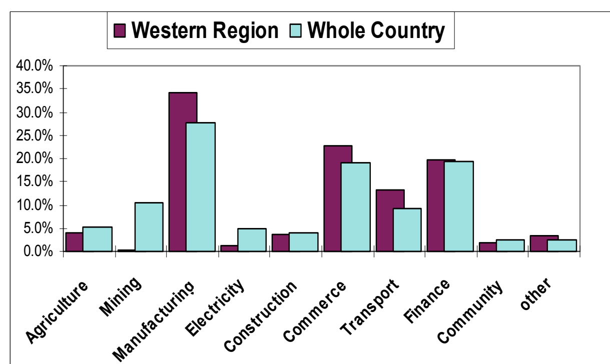
The manufacturing sector constitutes around 50% of the economy of this area, significantly more than the national average of 30% at that time. The remaining sectors conform closely to the national pattern, with construction somewhat over-represented, and finance less strong than in the rest of the country. This suggests a levy base which is proportionately stronger than might be expected. This is confirmed below.

East Vaal District, illustrated alongside, has the second largest economic base of all the non-metropolitan District Councils. The District includes the coal mining and electricity generating area North East of Pretoria. The chart provides an illustration of this, showing a preponderence of Mining, manufacturing, electricity and agricultural sectors, each of which contributes a larger proportion of the local economic activity than does its counterpart nationally.



By contrast the Western Gauteng Region, two places below it on the list, contains largely mining areas, particularly Krugersdorp, Randfontein and Westonaria.

The next largest District, the Western Region District includes the newly demarcated metropolitan area of Port Elizabeth and Uitenhage. The graph on the right indicates a spread of sectors that are close to the national pattern, with a stronger representation of manufacturing and commerce due to the local motor assembly industry. This is typical of any of the larger major cities.



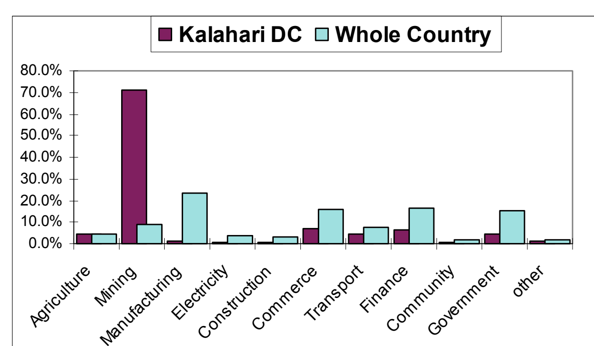
Ninth largest, the Highveld District includes the coal, electricity and steel producing areas of Witbank and Middelburg.

Top 10 Districts, GGP per Capita

DC	Total Levies	GGP (1993) Rx1000	Population	GGP per Capita
Western Gauteng	51,331,243	11,282,435	60,173	187,499
Eastern Gauteng SC	262,100,000	25,158,028	141,793	177,428
Pretoria Metro	242,000,000	32,022,607	1,331,827	24,044
Johannesburg Metro	621,418,000	58,050,786	2,729,609	21,267
Namaqualand DC	5,702,000	1,638,043	77,787	21,058
Kalahari DC	9,500,000	1,809,812	92,383	19,590
Kyalami Metro	105,000,000	8,659,174	555,599	15,585
Eastvaal DC	60,770,000	13,783,027	948,591	14,530
Cape Town Metro	378,000,000	39,713,704	2,753,701	14,422
West Coast DC	18,309,747	3,316,341	248,718	13,334

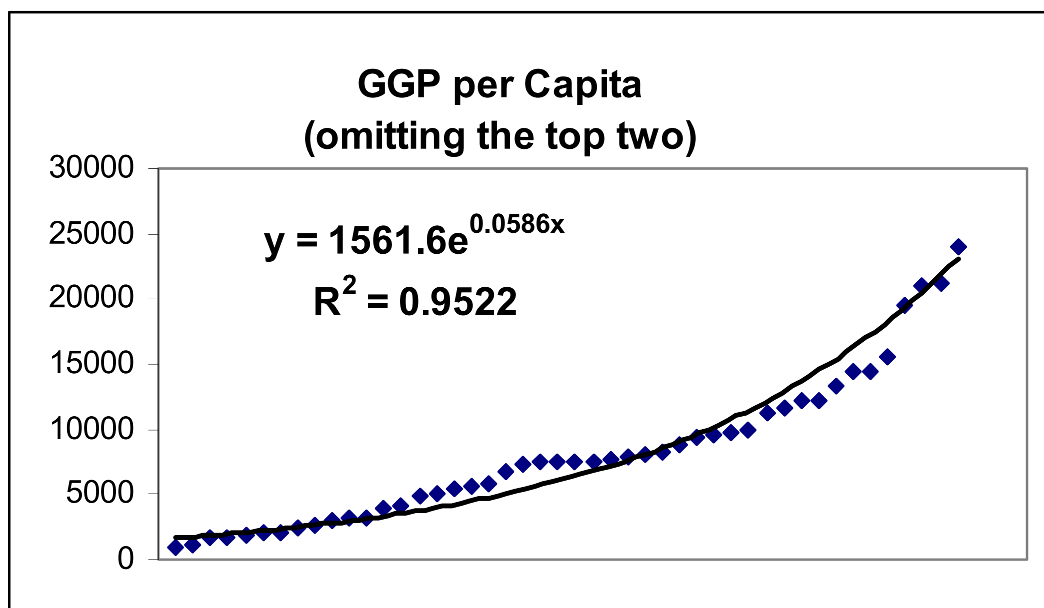
The table above, showing the top ten districts in terms of GGP per capita holds some surprises. At the top of the list are not the Metro authorities, but the two non-metro, Gauteng based districts. Their top position, by a large multiple is a result of a relatively low population combined with a high GGP. These districts are characterized by significant industries based outside the metro and urban areas, and relatively sparse populations. This pattern conforms to the conventional ring structure often observed in metropolitan economies worldwide. The Inner city is typically dominated by retail and office development, has a very dense population and a relatively low per capita value of economic output. In the next ring, light industries and commercial businesses prevail, with a somewhat lower population density. In the outer ring, consisting in this case of the areas represented by the Eastern and Western Gauteng District Councils, the economy is less diverse, focused on mining, heavy industry, and electricity generation. These industries are located in semi-rural areas, with a low population density. The GGP per capita is correspondingly high, as is the collection of levies.

Surprise entrants high up on the table are Namaqualand, Kalahari and West coast. These are all on the South Western coast of South Africa, are very sparsely populated, but have a significant economy, based on mining, agriculture and manufacture. Kalahari DC, illustrated on the right, is a semi-desert region, with 70% of the local economy comprised of a significant diamond mining sector. The presence of these three in the top ten per capita GGP results from the extremely low populations in this arid, semi-desert part of the country.



Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL



If we omit the top two Districts, Western and Eastern Gauteng as a-typical, we can see that the pattern of GGP per capita is far from constant, as might be deemed desirable. Rising from less than R1000 per capita in the Lower Orange River District to R24000 per capita in Pretoria. This indicates a very great variation in the levy base per capita, a variation that appears to bear no relationship with fiscal needs. Curiously, the GGP per capita of each DC is a very stable function of the one preceding it in the ordered list. 95% of the variation in per Capita GGP is explained by the position of the DC in the list of DCs sorted in order of GGP per Capita.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa
RTI INTERNATIONAL

ANNEX B
OTHER LOCAL GOVERNMENT REVENUE OPTIONS[19]

Irrespective of what happens to the RSC levy, there are other revenue options that might be considered for local governments. Three of these are covered below.

Proposal 1: Tax On Utility Sales

At present, most of the larger local authorities are dependent on surpluses earned from the sale of utilities, principally electricity. A net amount in excess of R2.5 billion 20 is collected in this way nationally. Gross utility receipts constitute as much as 42% of total local government cash flows nationally, as compared with property tax which accounts for only 15%. Despite the fact that over 90% of this is returned as costs, this large cash flow is an important element in the financial viability of local governments.

A process has been set in motion which will soon result in the removal of electricity as a direct function of local government, and as a result, the loss of this source of revenue to local government. This will generate an immediate crisis in local government. It is also unlikely that this will be the last such crisis. The process of restructuring the provision of utilities will be on-going, involving regulation, privatization, commercialization, outsourcing, partnerships and many other organizational forms of change, each of which would raise a new threat to local government if they remain dependent on electricity and other utility operating surpluses. It has also become clear that local government is captive to the power of central government in South Africa. Aside from direct legislative mechanisms, boundary changes, guidelines issued on privatization, commercialization and public private partnerships has had a profound impact. This places their ability to earn surpluses on utilities under the direct power the higher authorities, thus constituting a serious limitation on the effective fiscal independence of local authorities.

In recognition of the reality and inevitability of the on-going restructuring of public utility provision, we recommend that local government, including metro and district councils divorce their revenue from the operation of utilities, and rely on an excise tax on the sale of utilities as more secure, less easily challenged source of revenue.

Proposal

District Councils or their equivalent would be entitled to levy a tax on the value of utilities sold in their regions. The principal base would be the sale of electricity and water, which together amounted to about R18bn in 1998/99. It is therefore a productive base. In order to raise an equivalent of the yield of the current levies the rate would have to be increased by approximately 15%, from an average of 17c per unit to around 20c/unit.21 Individual councils should however be entitled to set a schedule of rates at the level dictated by their

[19] Note: These options are proposed by the authors on their own initiative, based on their knowledge and experience. They do not imply any endorsement or support from any other body.
[20] Source: NER. Costs are not fully allocated to utility provision, leading to a possible overstatement of this net figure.
[21] This is a rough estimate which does not take into account the sometimes complex structure of electricity tariffs. It indicates an average national rate of increase.

own requirements and policies and should be entitled to offer rebates or other relief mechanisms as in order to promote equity, to improve economic efficiency and as incentives for new businesses.

Evaluation

The surplus currently earned on utilities is an implicit tax, paid by all consumers and currently collected by some of the local governments for the benefit of residents within their jurisdictions. The excise tax which replaces it would be an explicit, visible charge, confined to the taxing jurisdiction, not easily overflowing the boundaries as the current surplus does.

It is a potentially productive revenue source, with a very extensive and elastic base. It is in principle applicable to all utilities regardless of whether surpluses or profits are earned on them. Water supply could be a substantial part of its base, despite the fact that most water suppliers operate at a loss, as could gas, irrigation water, or any other local utilities.

Equity: The equity of a tax on utilities is always questioned, and with good reason. Clearly, the proposed excise is superior to the present system. Surpluses constitute part of user charges paid by customers outside the borders of the region, representing a tax flow from one jurisdiction to another, with no commensurate benefit. This fundamental injustice resulted directly from the historical demarcation of jurisdictions on a racial basis by the apartheid government, and is much hated as a result. The proposed excise tax avoids this pitfall by collecting only from users who are based within the jurisdiction. The excise tax does not however avoid all inequities. The criterion of equity is violated, in respect of high volume consumers of utilities who through their charges pay a higher implicit tax, without necessarily being blessed with greater ability to pay, and without receiving greater benefit.

The stated intention of the process of demarcating the boundaries of new district councils is also potentially subverted by inter-jurisdiction fiscal flows implied by the existing utility structure. By collecting electricity payments over a wide area, and spending the surpluses in the white municipal areas, some apartheid cities enriched themselves at the expense of their neighbors. The proposed excise tax will eliminate this spillover effect and will ensure that the revenue accrues to the body intended to be financed by it, not inadvertently to a neighbor. It will thus be more visible and more equitable than the existing system.

Efficiency: There are some efficiency concerns surrounding the proposed excise. Any revenue source that impacts on the relative price of an input is, per se, inefficient in that it alters the marginal conditions which drive decisions regarding the efficient use of inputs. This is, however an inevitable consequence of taxation in general, indeed of any form of public appropriation, and cannot be escaped. It must, therefore, be seen as a part of the cost of a public sector. The proposed excise tax is not more inefficient than the existing mechanism of appropriating utility surpluses, and because it is levied on a service that is price inelastic in demand, it has limited impacts on economic decisions. If the implementation of this proposal is associated with appropriate regulatory reform of the utilities, this could mean an improved competitive environment for utility provision, with attendant efficiency gains.

Administration: An excise tax on utilities would be easy to administer and would have low compliance costs, requiring little or no additional record keeping. More importantly, this

proposed excise would be relatively robust with respect to the rapidly changing governance structures of the utilities.

Political acceptability: The on-going deliberations of the electrical industry as regards ring-fencing, cost allocation, ownership, appropriation of surpluses, or market territories would have little impact on the base of the proposed tax but will profoundly affect revenues arrangements as they currently stand. This characteristic alone leads us to favor this as a possible replacement for the levies. All spheres of government in SA are engaged in the restructuring of every enterprise in which government is involved. Electricity in particular is not likely to stabilize its industrial structure for some years to come, and the water utility is likely to be equally unsettled. The proposed tax on electricity sales effectively insulates this fiscal component from the other aspects of these industries, greatly simplifying both the debate around fiscal resources and that regarding industrial organization. In effect, such a tax would make the political choices concerning privatization, asset restructuring, or private sector participation in the public utilities much simpler. Political acceptability is thus also well served by this proposal.

Administration

We recommend that this excise tax be collected at the level of the Metropolitan or District Council, rather than at the level of the local authority or the Province. In the major urban areas in which large surpluses are currently earned, Metropolitan government are the bodies which now earn those surpluses, and will be the bodies which are entitled to collect the excise tax. In context, therefore, the proposal brings little change. In the secondary cities the profitability of the utility operation is very variable. Not all are successful in earning surpluses, and in the case where surpluses are earned; they are frequently earned not from urbanized industry, but from the primary mining sector. Transfer of this revenue source to the District Council would make it accessible to the whole region, including the rural areas in which the primary activity takes place. The loss of this source of revenue to the urban portion of the region would be compensated by a reduction of their responsibility for regional functions. Assignment of this source to Provincial government is not considered desirable. An excise tax on utility turnover creates a very desirable incentive system, since the degree of use of utilities depends very much on the level of development, both rural and industrial in the area. The utility excise creates a strong incentive to engage in effective local economic development, which is a key statutory role.

Required Legislation

The constitution specifically allows excise tax to be levied at the local level. The Systems Act also specifically allows for a surcharge of utility tariffs. There appears therefore to be no legal encumbrance to the implementation of this proposal.

Summary

- Municipalities earn in excess of R2.5bn per annum in electricity and water surpluses. In the electricity sector, 25% of distributors report a surplus, the rest report a loss on services rendered.
- Restructuring is about to take this revenue source away from municipalities.
- Electricity prices are relatively high for the region, but low in world terms.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL

- Price elasticity is low. Price, as a result of the tax, has little impact on consumption.

Positives	Negatives
Potentially very productive. The base is very extensive, the increase in the rate would be low. (around 15%) Fair, if incidence is the industrial user or mine. Administratively simple, utilizes existing data. Visible, transparent. Adaptable to the proposed changes in the governance of utilities	Inefficient: additional marginal cost on production, distorts input prices. Unfair if passed on to consumer or worker

Proposal 2: Surcharge On Property Taxes

The uneven geographic distribution of utilities payments makes reliance on this as the sole source of revenue undesirable. A surcharge on the existing locally collected property tax, with formula-based grants would form a stable, equitable base.

Proposal

One possibility is that District Councils be given the authority to collect a proportion of property taxes collected within their jurisdiction by local government. This will operate both within metropolitan areas as is currently the case and within the non-metropolitan District Councils. The proportion of the surcharge should be limited by provincial legislation, and can be varied at the discretion of the District Council. Variations of the surcharge within a council area should not, however be permitted, and in any case would be contrary to the constitutional requirement that a uniform taxation system be applied. By illustration, a surcharge of 5%, lifting the effective rate from 2% to 2.1% would, in 1998 have yielded close to R500m.

Evaluation

The property tax is generally accepted to be a suitable source of revenue for local government.

Fairness: It is closely related to benefit received when used to provide local services, which provide a suitable environment for local property. Many studies have confirmed that local government expenditure is capitalized in property values, so that the property tax may be seen as akin to a user charge, or a “rent” paid for local services rendered.

Efficiency: Being a tax on fixed capital, the efficiency effect is very limited, and is ameliorated by adoption of the site value tax variant, as practiced in Johannesburg. This is viewed by some as having a positive efficiency effect in that it discourages the practice of “land warehousing” which has cost implication for the local government (Solomon 1985). The tax also provides a healthy incentive structure for local government to provide services, which are valued by the community and enhance property values, thus improving revenue

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

prospects. Improved property values result in an increase in the property tax base, and an increase in the revenue yield.

Adequacy: The current burden of the property tax is low by world standards, providing sufficient room for expansion.

Economy of Administration: The administration of assessment and collection of the property tax is consistent with the maintenance of other economically virtuous services such as deeds registration, land surveying and maintenance of the local voters roll. Extension of the property tax thus creates the necessary mechanisms to encourage a viable property market.

Stability: The property tax base is stable and, providing assessment practices are sound, is reasonably elastic.

Visibility: The tax is highly visible, and as such enhances the spirit of local accountability and helps build democratic values. It is also, for this reason likely, to be resented, particularly in the current environment of threatened, "tax revolts" against property tax increases.

Administration

The rate of the property tax surcharge will be set by the Metropolitan or District Council. The council, in setting its budget will plan for an appropriate mix of the surcharge and the utilities tax, depending on the circumstances. Very few additional administrative provisions are necessary, but attention needs to be given to the quality of administration of the existing property tax as regards the regularity and consistency of assessment practices and the provision of tax relief to prevent sudden unexpected increases in the tax burden. In our view, a complete package of reforms should be presented to the taxpayer, including assessment reform, relief mechanisms including circuit breakers and caps, and a tax and service charge collection drive.

Required Legislation

Surcharging of property taxes by the Metropolitan and District Council is currently provided for in terms of the Systems Act and the Local Government Transition Act, but is not much used to date. There is also precedent in the use of the property tax to fund the former Divisional Councils in the Cape.

Proposal 3: Motor Vehicle Taxes

Motor Vehicle licenses are a provincial revenue source, collected on their behalf by many of the larger local governments. Passenger vehicle licenses are in the range of R100 per annum.

Description

There are several mechanisms for taxing motor vehicle usage:

- Annual unrestricted license fee (existing).
- Restricted license for entry into congested areas, such as CBDs, office parks, etc.

- Parking fees, taxes on off-street parking.
- Fuel tax (dealt with in separate report).
- Tolls.

	1992	1997	Fee, 1997	Yield (Rm)
Cars	3400000	6400000	95	608
Buses	25000	28000	1000	28
Taxis	210000	210000	140	29.4
Bakkies	1000000	1300000	100	130
Heavy	130000	140000	3500	490
		8078000	159	1285.4

Source: Own estimates

Potential

Revenue potential is good, but would require a major escalation of fees. An 80 percent across-the-board increase in existing fees would be required to raise R1bn per annum. For example, this would increase the private vehicle license from R95 (approx) to R171.

Year	Cars per 1,000 of population
1970	81
1980	97
1990	111
1997	160

There is no constitutional impediment to allocating this revenue source to Local Governments.

The base is however, growing rapidly, from 81 cars per 1,000 population in 1970 to 160 per 1,000 in 1997.

Major cities in the developed world have roughly 550 registered vehicles per 1,000 population.

Evaluation

Positives	Negatives
Elastic. The base is growing rapidly Efficiency is good: It is a credible benefits tax, on congestion and pollution. It is a credible rationing (Lindahl) tax. The marginal effect on usage is small (better than a fuel tax). Fairness is good. Administration is economical in the case of licenses, parking and fuel tax, using existing data and payment mechanisms.	Elastic only in urban areas. Efficient only if selectively applied, in areas where congestion and pollution are high. Would contribute to the decline of the CBD, already a concern. True Incidence (on user/consumer) is concealed. Administration costs are high if the congestion tax is selectively applied in the form of restrictive licenses, parking. Urban tolls are impractical.

- Road usage imposes several costs on the community that are not directly borne by the user.

- Congestion. A road users contribution to congestion is born largely by other road users.

- Pollution. The road use increases pollution, cost born by others.

- Road maintenance.

The imposition of a tax on road use can therefore be seen as an artificial price (Lindahl Tax). In order for it to operate as such, it would have to be selectively applied, to areas of congestion or of high pollution, otherwise it would constitute an over-pricing of a resource, and would be inefficient.

Proposal 4: Commercial and Industrial Taxes

Current Situation

Commercial properties are taxed at a rate almost double that of residential properties.

Description

It has been proposed to separate the commercial and industrial properties, and to apply a different form of property taxation to them than to the residential properties: i.e., full site and improvement rating based on an income stream valuation. This source of revenue could be allocated to Metro or District councils.

Evaluation

Positives	Negatives
A good alternative to the pure mega-city. Avoids some of the perceived inequities of the SVT.	Fairness is unclear, depending on incidence. Inefficient: Has a significant effect on location decisions at the margin.

Sponsored by U. S. Agency for International Development
for the Department of Provincial and Local Government, South Africa

RTI INTERNATIONAL