



PRECIUM  
INVESTMENTS

# The Cost of Non-Compliance

Why Government Should Link Corporate Income Tax Rates to the  
BBBEE Codes

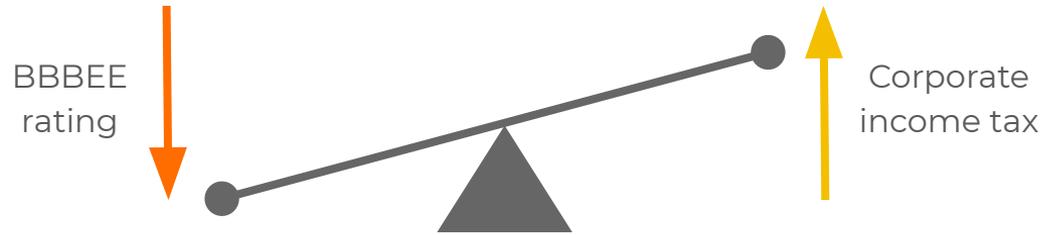
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# The Concept

In order for the state to increase the current and historical slow rate of economic transformation within South Africa, changes to corporate income tax rates should take place, and should be done in such a way that the lower the BEE rating attained by a company, the higher the amount corporate income tax (“CIT”) is due.



- The goal of such a change is not to increase tax; the goal is to increase transformation
- Adding a “surcharge” to pre-tax profits is effective means of motivating businesses to implement change

# Why Transformation is Important

What is the the primary purpose of BBBEE?

- “To establish a legislative framework for the promotion of black economic empowerment ...”
- Develop an equitable broad base of black people participating in the economy.
- Promote the economic upliftment of black citizens, the policy works to uplift broader society – bringing about much-needed socio-economic transformation.

What is the role of transformation in addressing the challenges of poverty, inequality and unemployment?

- Growth of 4% p/a between 1994-2007 was not sufficiently inclusive and labour intensive.
- Additionally, unemployment of 36% on broad definition, with 63% youth unemployment means that mainly black people are unable to participate meaningfully in the supply and demand side of the economy.
- 17 million (about 1 in every 3) of South Africans are dependent on social grants.

## What are the measurable results of transformation to date?

### Ownership

- BEE deals of JSE listed companies between 2000 and 2014 created net value of R317bn, only 2.75% of the total market cap of JSE listed companies. Total black ownership of JSE market cap, circa 2015, is estimated at 10%.
- Only 23% of unlisted companies are at least 50% black owned, with less than 5% being 100% black owned
- Only 18% of listed companies at least 50% black owned, with less than 1% being 100% black owned

### Management Control

- Management control lags targets, with close to 60% of companies failing to score half the available BEE points.
- Only 32% of JSE listed directorships are held by black South Africans (20% men and 12% woman). The majority of directorships still held by white men (62%).
- Only 5 black CEOs among JSE top 40 listed companies

## What are the measurable results of transformation to date?

### Enterprise/Supplier Development ("ESD")

- The number of formal SMMEs in South Africa has grown by 17.8% between 2008 and 2018.
- The percentage of black ownership of formal SMMEs increased from 30% to 34% between 2008 and 2015.
- GVA (gross value added\*) contribution from SMMEs increased from 18% to 22% between 2010 and 2015.
- Not all of this growth can be solely attributed to BEE, but it stands to reason that increased preferential procurement and supplier development spend contributed to the growth of SMMEs.

### Skills Development

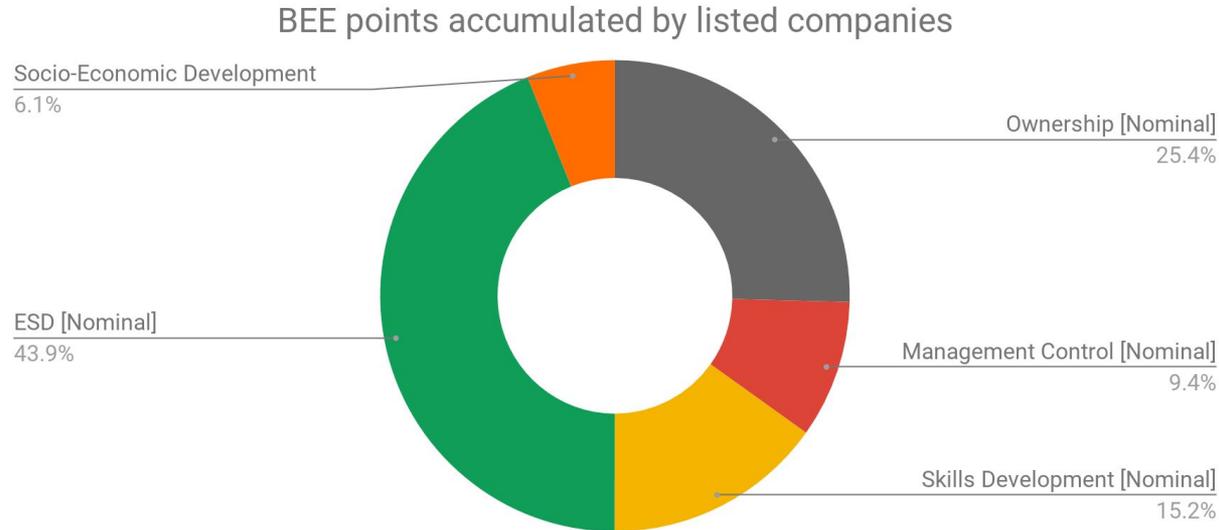
- The primary sector shed jobs between 2001 and 2016 (down from 15% to 8.3%), with tertiary services responsible for 90% of new job creation (up from 63.7% to 70.8%).
- Labour force participation has declined from 53.7% to 53.0% between 2005 and 2015, while unemployment has increased from 23.8% to 25.1% over the same period.
- It stands to reason that businesses in the tertiary sector have contributed to the development of required skills.
- The skills development scorecard portion of the BEE Codes is very granular making it difficult to validate (and thus, easy to manipulate).

### Socio-Economic Development

- SED contributions are any monetary or non-monetary contribution implemented for individuals or communities, where at least 75% of the beneficiaries are black.
- The majority of businesses, across all BEE levels, tend to meet the target contribution for SED.
- The broad definition of SED makes it difficult to quantify the impact of these contributions.

# How are businesses responding to BEE

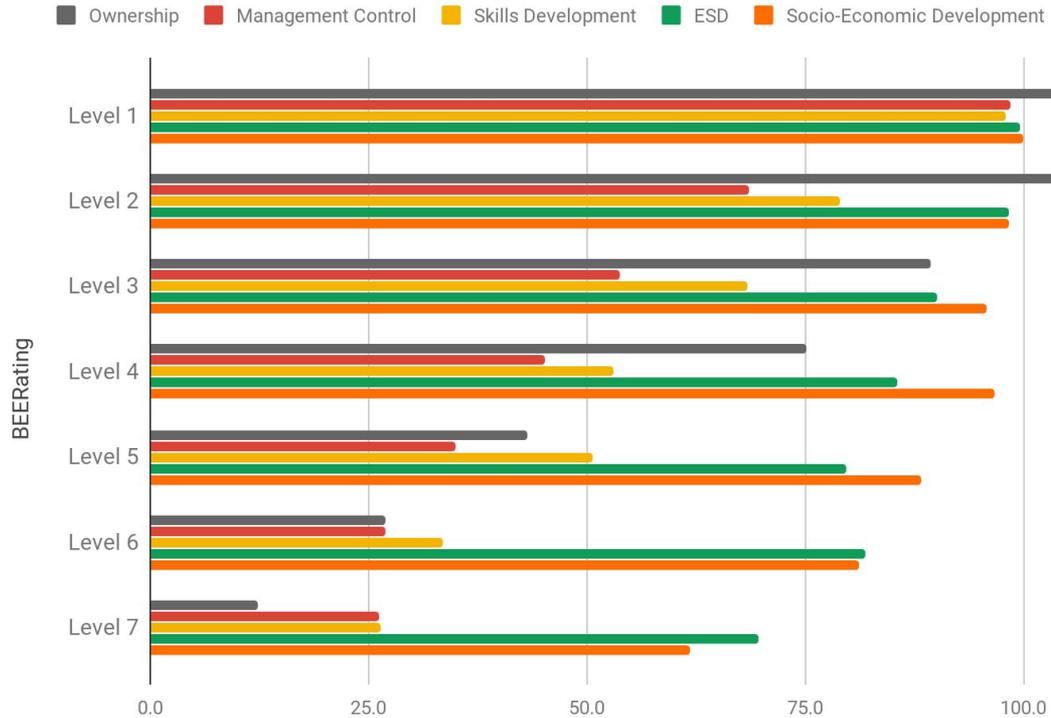
How can companies accumulate BEE points?



- ESD accounts for the majority of BEE points
- Companies, on average, fail to accumulate the majority of Management Control and Skills Development points.
- Socio-economic development is the best performing element, but it only offers 5 points so its overall contribution is small.
- Businesses with low BEE ratings perform poorly in the Ownership and Management Control elements. As ratings improve, performance tends to increase somewhat sequentially across the following categories: Ownership, Management Control, and Skills Development tends to improve.

# How are businesses responding to BEE

Points accrued as a percentage of available points per element  
across BEE levels



# How are businesses responding to BEE

- Businesses with low BEE ratings tend to collect a larger proportion of points from ESD. The codes make it relatively easy for businesses to accumulate preferential procurement points from *empowering suppliers* and supplier development points. It is important to note that only half of the available points for preferential procurement *specifically* relate to black suppliers.
- Businesses with lower ratings tend to have little black representation in terms of ownership and management. This indicates that the majority of white owned and controlled businesses continue to not see sufficient motivation to transform.
- Skills development is not a priority for businesses with low BEE ratings. This indicates that these businesses find it difficult (or costly) to implement learning programs for existing black employees or create learnership, apprenticeship and/or internships opportunities for new black employees.

# Concerns Raised, and Addressing those Concerns

## Concern Raised

## Addressing those Concerns

What about businesses that comply with the codes?

Businesses that are reasonably or fully transformed (level 1 and 2 ratings) can be made exempt from any additional CIT due.

Business need time to transform.

- It's been nearly 25 years since the Constitution was enacted and more than 10 years since the first BEE legislation was passed.
- As with most legislation, there should be a grace period (12 months) between approval and application of such changes to the relevant legislation, should this change occur.

Small and medium businesses will struggle to comply and increased CIT will be a massive burden on these businesses.

- The current Codes make it easy for businesses generating less than R50m/year in revenue ("qualifying small enterprises) and businesses generating less than R10m/year in revenue ("exempt micro enterprises") to achieve good BEE ratings.
- This proposed tax penalty only impacts profits, not revenue.
- Businesses with smaller profits would feel a smaller impact, and only those businesses who are highly profitable AND refuse to transform feeling a noticeable impact.

Businesses will pass on the cost to consumers.

Businesses that push up prices as a result of decreasing profit margin, will lose market share to more transformed competitors, who are exempt from the tax penalty and are able to maintain prices at the accepted market rate. That being said, there is a possibility of collusion between large producers of price inelastic goods, which could include low/lower cost food retailers as well as food producers (e.g. between Pioneer Foods, Tiger Brands and RCL, a large amount of the zero vat rated products are produced), who then go on to pass the prices onto their consumers.

# Concerns Raised and Addressing those Concerns

## Concern Raised

Businesses will retrench staff to recover cost.

Businesses can't afford the cost of complying with the codes.

Net foreign direct investment and investment from multinational corporations will reduce.

## Addressing those Concerns

Reducing the workforce will reduce total productive output, which in turn reduce competitiveness. Any businesses with lower level of competitiveness will lose market share to their more efficient competitors.

Businesses require education on the various options available to effectively increase their BEE rating and practical guidance on how to structure and execute these initiatives. A website can be created and popularized with simple explanations on the various practical ways businesses in various sectors can increase its BBBEE level

- While multinational companies take the CIT rate of the jurisdiction they are considering entering – or remaining in – into account, it is only one component of such a decision. The other major considerations include profitability and growth prospects.
- Sectoral growth and gross domestic product (GDP) can vary widely depending on the sector, with a number of sectors within South Africa showing much higher growth than national average GDP.
- Another important thing to bear in mind is that while foreign direct investment is important, it is a much smaller contribution to capital inflows than foreign portfolio investment (which relates to foreign capital flowing into the country to purchase sovereign and corporate debt, and to a lesser extent, equities).

# Socio-economic impact (high level)

## How could businesses respond to the proposed CIT penalties?

### **BEE reporting**

There is a low level of BEE reporting by businesses at the moment, with only 30% of the 401 listed JSE entities submitting reports. Businesses will be motivated to evaluate their BEE performance and submit their BEE certificates to avoid CIT penalties.

### **Skills Development**

Businesses will increase investment in staff through accredited training and learnership programmes. This has the added benefit of improving productivity and increasing the general skills base.

### **Ownership**

- Small businesses with 51% black ownership automatically qualify for a Level 2 rating, while 100% qualifies a business for a Level 1 rating.
- Increased black ownership will be facilitated through employee or community share schemes or by bringing in strategic black partners.

### **Management Control**

Management structures, especially boards and executive management, are dominated by white males. Businesses will implement targeted recruitment strategies (either hiring external applicants or promoting internal staff) to increase black and female representation throughout management.

## Scenario 1: Wide-spread transformation (*upside scenario*)

### Response

- A significant proportion of businesses choose to avoid CIT penalties by improving their BEE ratings .
- Large businesses start by increasing black ownership through BEE share schemes, increasing effective black economic ownership.
- Medium and small businesses follow suit, and bring in strategic black partners. Some take advantage of enhanced recognition, at 51% black ownership, qualifying for Level 2 ratings.
- Businesses put in a high degree of effort into identifying and developing BEE suppliers at a faster pace than previously in order to increase procurement points. Those businesses that choose not to transform feel increased pressure from their competitors to increase their BEE ratings.
- Targeted recruiting and retention policies lead to more representative management teams.

### Impact

- There is a significant shift in transformation, especially across medium and large businesses, most notably in Ownership, Management Control, and ESD elements.
- Over time the redistribution of economic ownership and increased participation result in a more equitable distribution of wealth, contributing to a growing middle class and expanding the consumer base.
- Increased preferential procurement stimulates the growth of SMMEs, allowing these businesses to create more employment opportunities.
- The base of BEE suppliers increases which enables more businesses to source locally, reducing net imports and stimulating economic growth.
- Increased investment into training and learnership programmes closes the skills gap, increases labor force productivity, competitiveness and innovation. This leads to an increase in entrepreneurship and expansion in certain sectors/industries.
- Because most businesses achieve good BEE ratings, there is no significant increase in CIT revenue.

# Socio-economic impact (high level)

## Scenario 2: Limited transformation (*middle of the road scenario*)

### Response

- Some businesses see the CIT penalties as a sufficient motivation to transform, while others choose to rather pay the surcharge.
- The majority of EMEs and QSEs find it easy to transform, taking advantage of enhanced recognition related to the Ownership element to achieve level 2 ratings. Others, who choose not to give up a majority stake in their businesses, leverage Socio-Economic Development, Management Control, and EDS elements to improve ratings.
- Larger businesses increase BEE ratings through Ownership, Management Control and ESD.
- Loss making business, especially new and growing businesses, are not affected by a CIT penalty. Some of these businesses choose to focus on building their businesses, while others take a proactive approach and start the transformation journey early.
- There are limited cases of the businesses opting to shutter or move operations rather than transform.
- There are isolated cases of companies that hold monopolies within their industries attempting to pass the cost of noncompliance on to their customers.

### Impact

- There is an increase in CIT revenue (likely between 3% and 6% on a base of R231.2bn, or R6.936bn and R13.872bn) from businesses that choose not to transform.
- Transformed businesses gain an advantage over their less transformed competitors, and over time this allows them to grow at a higher rate and produce more attractive returns. These businesses create more job opportunities and continue to build on their transformed culture.
- There is a meaningful shift in transformation, especially across medium and large businesses, most notably in Ownership, Management Control, and ESD elements.
- Increased economic participation, through ownership and employment, for black people leads to a more equitable distribution of wealth and a more integrated society.
- An uptick in preferential procurement contributes to the growth of SMMEs, stimulating local economic activity, leading to job creation.
- Investment in skills development and internships/learnerships create more employment opportunities, especially of the youth.

## Scenario 3: Negative response (downside scenario)

### Response

- In sectors where the market is dominated by a relatively small number of players, as well as inelastic price demand for their products offered, collusion occurs. Faced with impending CIT penalties, given low BEE ratings, businesses agree to recover the cost through a coordinated effort to increase prices. The penalties are thus passed on to their customers and eventually to the end consumer.
- Multinational organisations and investors fail to see the macro benefits of economic transformation. Given the cost of non-compliance with BEE regulations, they choose to move their operations elsewhere South Africa. Possible new entrants choose not to invest in South Africa. This results in an increase in net FDI outflow.
- Businesses that are in cyclical industries, and that have a high fixed cost ratio, rely on profits made during good periods to see them over in loss making or low profit periods. Untransformed and marginally profitable businesses like these, already under economic pressure, don't find benefit in investing in transformation. The CIT penalties further erode profits, reducing returns and the business case. These businesses close down, resulting in job losses and economic production.

### Impact

- There is a no meaningful shift in transformation.
- Consumers absorb price increases, reducing disposable income and driving up inflation. The reserve bank responds by tightening monetary policy, increasing interest rates to keep inflation in the target range. This increases the cost of debt repayment, further constraining consumer and business, but creating a more attractive investment case for foreign investors.
- FDI decreases as some foreign investors deem the risk of increased CIT to outweigh the potential benefit of setting up operations in South Africa.
- There is no direct increase in economic activity as a result of this change in legislation and no new job are created.

### Absolute Worst Outcome

- The average effective CIT rate increases, but on a nominal basis CIT revenue stays flat as a result of the decreased corporate tax base due to businesses closing or moving operations, leading to economic contraction and job losses.
- For this to occur, the majority of cyclical businesses would have to shutter operations. Multinationals would have to see the changes as a significant threat, thus closing or moving their operations.
- This does however create an opportunity to use a portion of CIT revenue to finance black entrepreneurs to acquire abandoned assets at a discount, driving transformation and the redistribution of assets and economic participation.

## Legislative Amendment

### Public Engagement

- Green Papers are a useful, but not compulsory, method to initiate discussion with interested parties and invite comments and suggestions.
- White Papers are more refined discussion documents that addresses the broader governmental and legislative framework regarding the relevant topic.
- Green/White Papers are drafted by the relevant Ministry/Department. Amendments to the BBBEE Act will be drafted by the Department of Trade and Industry, while amendments to Income Tax Act and/or Companies Act will fall under the Ministry of Finance.
- These documents will serve as input to the draft Bills.

### Initiation

- A Bill may originate from a number of bodies, including Ministers, Members of the Executive Council (MEC), Members of Parliament (MPs), Members of Provincial Legislature (MPLs), and Committees.
- A draft Bill, drafted by the relevant government department, is submitted by the relevant Minister to the Cabinet for approval.
- State law advisers refine and approve the draft Bill.
- Bills are classified by the Joint Tagging Mechanism (JTM) to determine the process the Bill must follow to become a Law.
  - Ordinary Bills that don't affect the provinces (Section 75 Bills) amendments are introduced at the National Assembly (NA).
  - Money Bills, that deal with the allocation of public money for a particular purpose or impose taxes, levies or duties (Section 77 Bills), may only be introduced by the Minister of Finance at NA.

## Legislative Amendment

### Tabling in Parliament

- The Bill is introduced and tabled in the NA for what is known as the First Reading and gets published in the Government Gazette.
- The relevant Committee considers the Bill and may agree to it, propose amendments or reject it, generally after a process of public consultation.
- The Second Reading then takes place at the NA where the Bill is debated and voted on by the 400 members.
- If there is a majority of votes in favour, the Bill is passed and it is then referred to the National Council of Provinces (NCOP) for consideration.

### NCOP Referral

- If the NCOP passes the Bill without amendments, it proceeds to the President for signing.
- If the NCOP proposes amendments to or rejects the Bill, it must go back to the National Assembly for reconsideration. The National Assembly can pass the Bill with or without the NCOP amendments, or it can reject the Bill.
- The NCOPs role is therefore limited as it can at most delay a Bill, but it cannot prevent it from being passed. The NA may choose to drop the Bill if compromise with the NCOP cannot be reached.

### Signing into Law

- Passed Bills goes to the President for his assent and signature. Once signed by the President, the Bill then becomes law.
- The Act or Amendment appears in the Government Gazette and comes into effect on a date determined by the President.

Thank You