



# PRECIUM INVESTMENTS

*What would happen if the government changed corporate income tax ("CIT") rules to link the CIT rates with a company's BEE rating? In this article, I explain how the BEE Codes actually work, how changing the CIT rules in such a way change lead to powerful and positive change, and finally how to solve some of the major challenges of such a change.*

At the heart of the idea of justice is quite simply, a desire for fairness. Fairness is so entrenched in the creation of this democratic version of South Africa that you will find the themes of fairness and equality littered throughout our constitution. Chapter 2, section 9, of our constitution discusses the right to equality and states that "*Equality includes the full and equal enjoyment of all rights and freedoms.*" This right to equality includes the right of all South Africans to participate fully in the economy of the country.

The South African constitution, like many of the laws that have flowed from that document, is highly progressive and focused on creating a just society. However, those laws often don't impact the lived reality of those it intends to protect or assist. For the millions of South Africans who have been ill-served by our democracy, economic transformation is one of those very good ideas that have failed to be properly implemented over the last 25 years. Should you spend some time reading the 107 pages of the 2013 broad-based black economic empowerment ("BEE") codes (the "Codes"), along with the latest 55 page amendment that came out in 2018 (which relate to enterprise and supplier development), you will see a well drafted concept. If the Codes were actually followed by all players within the economy, it would create wide-sweeping positive changes in regards to developing skills, creating jobs for black people, growing micro and small business (whose owners need not necessarily be black), and generally uplifting the quality of life of most South Africans.

The problem lies in that the Codes are completely voluntary and are akin to a nice suggestion on how companies should behave. If a company doesn't feel like abiding by the Codes, it need not, as it is only if one needs the government for licenses, or does a material amount of trade with the government, that the Codes have any bearing on a company.

Sometimes the reason for not transforming a company or compliance with the Codes can relate to practical operating constraints, as is the case with some micro or small businesses. However, in regards to medium and large businesses, it's often because company leadership simply does not deeply care about the people within this nation, or are overtly racist.

For those who aren't familiar with the Codes, let me simplify how the Codes work, and how it focuses on creating greater economic participation and transformation of the economy. I also make reference to more transformed or less transformed companies. More transformed companies are companies with a higher BEE level/score and less transformed companies are those with a lower BEE level/score.

The Codes specify how companies earn points that when added up lead to their overall BEE level, along the following lines: how much a company contributes towards developing small black enterprises and suppliers, how much a company contributes towards developing small enterprises and suppliers (regardless of the race of the business owners), as well as buying goods and services from black businesses and small businesses (this is the largest portion of the Codes, accounting for just under 40% of the total score), how much shareholding and control within a company is in the hands of black people (which accounts for approximately 20.5% of the total possible score), how much a company contributes towards developing skills in the country (approximately 20.5% of the total possible score), how much black management control there is, across all levels of management within a company (approximately 15.5% of the total possible score), and how much general socioeconomic development a company does (the smallest portion of the Codes, with around 4% of the total possible score).

A simplified table of what makes up the BEE Codes would look like this:

| Section                             | Weight |
|-------------------------------------|--------|
| Enterprise and Supplier Development | ~40%   |
| Black Shareholding                  | ~20.5% |
| Skills Development                  | ~20.5% |
| Black Management                    | ~15.5% |
| Socioeconomic Development           | <5%    |

At every level, the BEE Codes are a good attempt at creating greater justice in a society that is structurally, brutally, unjust.

In order for the Codes, which are already entrenched in South African culture, to realize their potential, they must be linked to corporate income tax ("CIT") in a way that says "should you comply to the Codes to a high degree, you get to keep paying 28% on the profits your company makes. If you don't comply to a high degree, you will pay more tax." Taxation is a powerful lever for behaviour change, as all profit-making companies are obliged to pay it, with little room to escape such an obligation. As the saying goes, the only things certain in life are death and taxes. The motivation behind such a specific change to taxation would not be to increase the level of taxation, but rather, to increase the level of transformation, with increased taxes only being paid by those companies determined not to participate fully in what can be considered a national duty for all South Africans. There are many versions of this approach which are possible to be created, but a staggered approach wherein a level 1 and/or level 2 company would still pay the current CIT rate of 28%, but level 3 companies would see an increase to 29%, level 4 to 30.5%, level 5 to 32.5%, etc. is a reasonable route to follow. The number of large companies that remain, 25 years after democracy, heavily untransformed (e.g. PicknPay, Mr. Price and Remgro, to name but a few, all have a BEE level 8 as at the end of 2018) is testament to the reality that there are many business owners who are not motivated to act in the broader interests of South Africa. Even Spur, a brand which is beloved by both racists (Spur's 2018 annual report, and reporting within the media, have made mention of the high number of racist incidents that occurred at Spur) and non-racists alike, has such poor levels of transformation that it is non-compliant, not even managing to get a paltry level 8.

As companies move along the scale from less transformed to more transformed, some interesting things can be observed in regards to the nature of how they interact with the society they are a part of (these observations are derived from the substantial amount of BEE compliance and assessment data we collected which related to thousands of different companies). Firstly, level 1 and level 2 companies often have a level of black ownership that exceeds what is required to attain maximum amount of points from this section. This means that as companies become transformed to this degree, they typically go above and beyond. Secondly, whilst management control and skills development steadily and gradually increase, companies undertake much more significant enterprise and supplier development. Enterprise and supplier

development is back-breaking work, but the type of work that ultimately reshapes the nature of the economy by directly supporting black and small businesses grow.

In proposing this idea, I am aware that there are a number of potential issues that could exist in such a change. The first issue that can be raised is that "companies need time to transform." However, there has been over two decades since the constitution was enacted, and more than a decade since the first BEE legislation was passed, signaling to business the need to transform. Additionally, and as with most legislation, a grace period (potentially between 12 - 18 months) should exist between approval of this kind of legislative change and its application, to allow for companies time to make the needed changes.

The second issue that can be thought of is that: "small and medium-sized businesses will struggle to comply, and increased CIT will be a burden on these businesses". In response to this I raise the fact that the BEE Codes create specific allowances for 'exempt micro enterprises' (companies that generate less than R10m per year in revenue) and 'qualifying small enterprises' (companies that generate less than R50m per year in revenue) that make it easier for these sizes of businesses to achieve high BEE levels. It's worth stating the obvious too, in that the additional tax only impacts profits, not revenue. This means that companies with smaller profits would feel a smaller impact, and only those companies that are highly profitable AND refuse to transform would feel a noticeable impact.

The third issue: "Companies will pass the cost of the additional tax on to consumers". This isn't a blanket tax, evenly applied to all companies, so individual companies that push up prices would possibly lose market share to more transformed competitors, who are exempt from added tax, and maintain prices at a more acceptable market rate.

The fourth issue: "Businesses will retrench staff to recover the lost profits from the added tax". Similar to the point above, because the tax is not uniformly applied, it allows for competition. Any company that reduces its workforce, in response to this tax change, would likely reduce total productive output, which

in turn reduces competitiveness, and would lead to a loss of market share to other, more competitive businesses.

The fifth issue: "companies can't afford the cost of complying with the Codes". Businesses require education on the various already-existing, cost-effective options available to easily increase their BEE level, as well as practical guidance on how to structure and execute these initiatives. Something as straightforward as a website with simple explanations on the various practical ways companies in various sectors could increase their BEE level, could be created and popularized.

And finally, the sixth issue: "net foreign direct investment and investment from multinational corporations will reduce". Whilst multinational companies do take the tax 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 relate to the current level of profitability (which relates to existing multinationals operating within South Africa), and what growth prospects exist for any multinational entering the country, or looking to expand. Growth in South Africa is tepid, but for most companies, what matters most is growth of demand within the particular sector or sectors they operate in. Sectoral growth and GDP growth can vary widely depending on the sector, with a number of sectors within SA showing much higher growth than national GDP growth. Another important thing to bear in mind is that whilst 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).

Change can cause fear, because of the uncertainty that the upcoming change would not be positive. What I've addressed here isn't a comprehensive list of all the possible fears related to this kind of legislative change, along with the reasons why those fears should be put to rest, but it is a start. One thing that all people can get behind is that in the long run, building a country that has greater fairness in it is going to benefit all parties, and that linking the BEE Codes to CIT rates possibly a mechanism that helps us achieve just that.