

Green charges or taxes and related income tax and value-added tax issues

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The introduction of green charges or taxes in South Africa as an environmental management tool is currently under discussion and debate. Pressure from the Department of Environmental Affairs and Tourism (DEA&T) is currently being brought to bear on Government to introduce such green charges (also referred to as the use of market-based instruments).

The DEA&T started a comprehensive research project in 1993 on the use of market-based instruments in South Africa. The conclusion was drawn that market-based instruments should be implemented as soon as possible as an environmental management tool. The possible introduction of green charges or taxes in South Africa also featured in several other discussion documents, green papers and white papers on environmental issues.

The above-mentioned documents consider the use of green charges or taxes and do not deal with related issues such as the income tax and value-added tax (VAT) consequences. This research paper attempts to address the related income tax and value-added tax issues and consequences of the use of certain market-based instruments. Market-based instruments refer to the different bases on which the green charges or taxes may be levied. It is of the utmost importance that these issues be dealt with before the introduction of green charges or taxes, as they will influence fiscal policy and planning as well as the effectiveness of the tax base or instruments used in environmental management.

KEYWORDS

Green taxes, green charges, user charges, market-based instruments, VAT, Income Tax.

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INTRODUCTION

The idea of levying green charges or taxes is an old concept and can be traced back to Pigou's work in 1920 (Lubbe *et al* 1999:74; Andersen 1994:4; Yandle 1991:35). The crux of the concept is that the price of goods and services does not include the cost of harm done to the environment and the consumption of scarce resources (Vos 1997:247; Lubbe *et al* 1999:74; Andersen 1994:4).

By levying some form of charge or tax, an attempt is made to incorporate the cost of pollution and the cost of utilising a scarce resource into the price of the product (McChesney 1991:163; Vos 1997:247; Von Weizsäcker *et al* 1992:16). The main objective thereof is to change the behaviour of polluters and consumers (Barbier 1993:155; Jenkins *et al* 1994:2; Barde *et al* 1994:24). Polluters and consumers will receive incentives to change their behaviour, to adopt cleaner technologies, introduce new management practices or change their consumer patterns, in order to avoid the payment of green charges or taxes (DEA&T 1997).

During 1993 the Department of Environmental Affairs and Tourism (DEA&T) started a comprehensive research project on the use of market-based instruments in South Africa. Thirteen research reports followed and four discussion papers resulted (DEA&T 1997:16). The DEA&T concluded from its research that green charges should be introduced to protect the environment since current legislation and regulations are not achieving this goal (DEA&T 1997:1-2). In addition, the possible use of green charges or taxes also featured in several other discussion documents, green papers and white papers on environmental issues (DEA&T 1996; DEA&T & Department of Water Affairs and Forestry 1998; Ministry of Environmental Affairs and Tourism 1998; Department of Minerals and Energy 1998; National Committee on Climate Change 1998). However, none of these documents deals with the related tax issues and consequences for income tax and value-added tax (VAT).

The use of green charges or taxes will generate revenue for the government (Deloitte & Touche Consortium 1994:6). The application of the revenue will determine the

nature of the payment, and whether it will be regarded as a user charge, a tax or an earmarked tax (also referred to as a levy). Two opposing streams of thought have developed on how the revenue should be applied, either that the revenue should be used for tax reform purposes or that the revenue should be used for environmental purposes.

The supporters of the tax reform philosophy are of the opinion that these taxes should not increase the total tax burden of a country but that they should be used to replace taxes on good activities (for example, taxes on labour and savings) with taxes on bad activities (for example, taxes on pollution). A double dividend will be achieved, namely a better environment and a better tax system (Oates 1995:916; Bovenberg *et al* 1997:208; Barde *et al* 1993:27; Repetto *et al* 1992:11; Ekins 1997:150; Baker 1997:196; Gee 1997:82; Von Weizsäcker *et al* 1992:9; Barde 1997:232). The effect of this approach is that the revenue generated by market-based instruments will be treated as a tax.

On the other hand, environmentalists (including environmental authorities) argue that the revenue from market-based instruments should be applied to protect the environment and should be treated as user charges (DEA&T 1997:2) or as dedicated or earmarked taxes (Andersen 1994:4). The distinction between user charges, taxes and earmarked taxes is essential in an evaluation of the issues regarding the treatment of market-based instruments for income tax and VAT purposes.

OBJECTIVES

The objectives of this research are to:

- distinguish between the terms "user charges", "taxes" and "earmarked taxes" in order to evaluate the related tax issues and consequences of market-based instruments;
- identify the various bases or instruments that can be used to levy green charges or taxes, with an indication of their application with regard to pollution, the use of scarce resources and waste generation; and
- discuss the related income tax and VAT consequences of and issues relating to these instruments.

THE DISTINCTION BETWEEN USER CHARGES, TAXES AND EARMARKED TAXES

In order to evaluate the related tax issues of market-based instruments, clarity on the differences between user charges, taxes and earmarked taxes is of utmost importance. A user charge is a payment for services rendered by the State, and payments vary with usage (Spackman 1997:47). The revenue from user charges does not form part of the National Revenue Fund (Katz Commission 1998:paragraph 4.5; Spackman 1997:45; Wagner 1991a: 7)). User charges are currently applied in South Africa to water and electricity supplies and the removal of sewerage and solid waste. It is the view of the DEA&T that the revenue from market-based instruments should be classified as user charges and should not form part of the tax base (DEA&T 1997:13). The question of whether the revenue from these instruments could be classified as user charges is uncertain and falls outside the scope of this paper.

A tax normally does not buy a direct benefit for the taxpayer and the payment goes straight into the state's coffers (Yandle 1991:38; Wagner 1991a:8). However, when a tax is set aside for a specific goal it is called an earmarked tax or levy. (Anderson 1991:16; Wilkinson 1994:119). In cases where green taxes are set aside for environmental goals, they will be classified as earmarked taxes. Earmarked taxes or levies raise the tax burden (Department of Finance 1999:chapter 6; Lee 1991:73). The distinction between other taxes and earmarked taxes is therefore not of importance when evaluating the income tax and VAT consequences of market-based instruments since both are regarded as taxes.

MARKET-BASED INSTRUMENTS

The DEA&T identified the following income-generating instruments that can be used as environmental tools, namely marketable permits, emission and effluent charges, product charges, resource charges, the deposit-refund system and two-tier charges (DEA&T 1997). A further two market-based instruments were identified in the literature review, namely a coupon system (Heister *et al* 1993:106) and the levying of an administration charge (OECD 1975). The problem with the use of market-based instruments is that no single instrument is suited to all environmental problems (DEA&T 1997). To illustrate the problem, the instruments identified above will be individually discussed below.

Marketable permits

Marketable permits are used to create markets, in which participants can buy or sell rights for actual or potential pollution. Under this approach, dischargers operate under some multi source emission limit and trade in the marketable permits is

allowed up to that limit (Barde *et al* 1997:23; CSERGE 1996:chapter 4). Marketable permits have proved capable of providing incentives for polluters to adopt cleaner technologies or new management practices, to reduce air pollution caused by industry, water pollution caused by chemicals in mining and agrochemical pollution (DEA&T 1997:32).

Emission and effluent charges

Emission and effluent charges can be defined as charges on the release of pollutants into the air and water or onto land. These charges are usually based on the quantity and quality of the pollutant discharged (Barde *et al* 1997:23; DEA&T 1997:27; CSERGE 1996:chapter 4).

Product charges

These are charges or taxes on products that cause pollution in the manufacturing or consumption phase. Product charges can either be based on some product characteristic (for example, a charge on the sulphur content in mineral oil) or on a product itself (for example, a charge on mineral oil) (Barde *et al* 1997:23; DEA&T 1997:27; CSERGE 1996:chapter 4).

Resource charges

Resource charges are levied on the use of a natural resource. They are mainly applied to the use of fossil energy sources and scarce renewable or non-renewable resources such as minerals, water resources and indigenous forests (DEA&T 1997:42).

The deposit-refund system

In deposit-refund systems a deposit is paid on products which have the potential to pollute the environment. When pollution is avoided by returning the product or its residuals, a refund follows. Deposit-refund systems are appropriate for products or substances which can be re-used, recycled or returned for destruction (Barde *et al* 1997:23; DEA&T 1997:50). The deposit-refund system is used for a variety of materials including vehicle tyres and car bodies (Jenkins *et al* 1994:53).

Two-tier charges

Two-tier charges are used to promote reasonable access to a scarce resource, making a limited amount of the resource available at a fair price to satisfy basic needs, while on the other hand, restraining the excessive use of the scarce resources (DEA&T

1997:46; Lee 1991:70). Two-tier charges can be used, for example, for water pricing (DEA&T 1997:46) and even on peak load electricity demand (Lee *et al* 1991:113; Wagner 1991b:83). It should be noted that the two-tier charge system could only be used where government is in control of the resource. The two-tier charge system falls into the category of user charges.

Coupon system / permits

Under the coupon system, the right to pollute up to a certain level is given only for a short period of time, for example, one year. There is no trading under the coupon system (Heister *et al* 1993:106). It is used, for example, for air pollution caused by industry.

Administration charges

The DEA&T can levy a charge on the administration of and control over pollution and pollution limits. It stands to reason that polluters should also pay for administration costs, but currently this cost is borne by the taxpayers (OECD 1975: 27) These charges are similar to the Regional Service Council (RSC) levies.

INCOME TAX CONSEQUENCES

The income tax consequences of these instruments for both the receiving and the paying parties will be discussed. The following sections in the Income Tax Act, No 58 of 1962 as amended will be addressed, namely: sections 1 (gross income definition); 10(1)(a) and (b); 11(a); 23(d) and 11(gA).

Gross income definition and exempt income

"Gross income" is defined in section 1 of the Income Tax Act and excludes receipts or accruals of a capital nature. The main issue under discussion will be whether the revenue generated from the sale of market-based instruments will be of a capital nature or not.

"Capital nature" is not defined in the Act and the interpretation of the term was left to the courts (Huxham & Haupt 1999:22). Income derived from capital employed is of an income nature (Clegg *et al* 1999:5-4, with reference to case law). The golden rule to establish the nature of a receipt or accrual when an asset is disposed of, is the test of intention: with what intention did the taxpayer acquire and hold the asset? (Arendse *et al*, 1999:20, with reference to case law). Did the taxpayer embark on a profitmaking scheme by treating the asset as trading stock? (Huxham *et al*, 1999:23-24, with reference to case law).

Discussion

Most of the revenue generated by the market-based instruments will be received by or will accrue to government, provincial administrations or local authorities. The revenues of the government, any provincial administration and local authorities are however exempt from income tax (section 10(1)(a) and (b)).

Eskom is owned by the state, but became a taxpaying entity from 1 January 2000. The additional revenue raised, by applying a two-tier charge system to electricity supplies, will be gross income and taxable in the hands of Eskom. It is important to note the two-tier charge system can only be regarded as a market-based instrument and part of user charges if the government maintains control of Eskom.

A marketable permit is the only instrument that is capable of generating revenue for a taxpayer. When a taxpayer sells a marketable permit, the test of intention is applied. The intention of the taxpayer when acquiring a right to pollute will in most instances be to secure the continuation of a business operation. Without a permit, closure of the business will result. This right will normally be part of the business structure and will be of a permanent nature. If a polluter sells off excess permits, then the proceeds in most cases will be regarded as being of a capital nature. When a taxpayer, however, starts speculating in pollution rights, the rights will be regarded as trading stock and the proceeds will be gross income.

Table 1: Summary of income tax consequences for the receiving party

Market-based instrument	Receiving party	Taxable
Marketable permits	State	X
	Taxpayer (subsequently sold)	See discussion
Emission and effluent charges	State	X
Product charges	State	X
Resource charges	State	X
Deposit-refund system	State	X
Two-tier charges	State	X
	Eskom (from 2000)	✓
Coupon system	State	X
Administration charges	State	X

THE GENERAL DEDUCTION FORMULA

The next issue to be addressed is whether the payment for green charges or taxes by the polluter will qualify as a deduction for income tax purposes in terms of the general deduction formula. Section 11 of the Income Tax Act states that there shall be allowed as deductions from the income of any person carrying on any trade within the Republic:

"(a) expenditure and losses actually incurred in the Republic in the production of the income, provided such expenditure and losses are not of a capital nature;"

To determine the tax consequences of green taxes and charges, the following questions should be considered: (a) was the expenditure incurred in the production of the income? and (b) was the expenditure not of a capital nature? These issues will be addressed individually.

(a) In the production of income

The courts interpreted the phrase "in the production of income" as follows in *Port Elizabeth Electric Tramway Co Ltd v CIR* (8 SATC 13 at 16-17):

"The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible... It follows that provided the act is *bona fide* done for the purpose of carrying on the trade which earns the income the expenditure attendant on it is deductible. It seems, however, that this statement may require qualification in one respect. If the act done is unlawful or negligent and the attendant expense is occasioned by the unlawfulness or, possibly, the negligence of the act, then probably it would not be deductible... The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operations provided they are so closely connected with it that they may be regarded as part of the cost of performing it."

In *Cot v Rendle* (26 SATC 326 at 331) the phrase "attached to it by chance" from the above case, was explained as follows:

"In deciding whether such an expenditure is deductible, it seems to me the inquiry must be whether the 'chance' of such expenditure being incurred is sufficiently closely connected with business operation..."

Discussion

The question that needs to be answered is whether the payment for green charges and taxes can be seen as an expense incurred in the production of income. The act that resulted in the expense being paid will be a production, manufacturing or mining process. When these processes are performed for the purpose of earning income, the payment for pollution is closely connected with the business operations. It is submitted that green charges and taxes will therefore be expenses incurred in the production of income.

When payments are made because levels of pollution exceed the legally prescribed limits, or because of the contravention of environmental legislation, such payments will constitute fines, as the act involved was unlawful. These types of payments will probably not be seen as being incurred *bona fide* in the production of income.

(b) Not of a capital nature

Expenditure will be of a capital nature if it is linked to the income-earning structure of the taxpayer, which allows him to generate income (Clegg *et al* 1999:10-18, with reference to case law). When considering the nature of the expenditure and its links to the capital structure of the taxpayer, the distinction between "fixed" and "floating" capital must be remembered. The acquisition of fixed capital is of a capital nature (Clegg *et al* 1999:10-19, with reference to case law). In *CIR v African Oxygen Ltd* (25 SATC 67 at 77) the test of enduring benefit was applied to decide whether a right is of a capital nature or not:

"Depending upon the nature of the enterprise and the benefit, a lesser degree of permanence would be sufficient. In relation to the respondent's business the benefit here in question is, I think, of sufficient permanence and substance unquestionably to qualify the right...it forms part of the capital assets of the respondent."

Discussion

It is submitted that all recurring expenditure or charges (whether classified as a tax or as a user charge) or direct charges or taxes (for example, resource or product or deposit charges or taxes) that are levied on products that are used as trading stock, will be of a non-capital nature and therefore will be deductible for income tax purposes. Only when the charges or taxes relate to the acquisition of fixed assets or

marketable permits, will the expenditure be regarded as of a capital nature and not deductible in terms of section 11(a). When a taxpayer, however starts speculating in marketable permits, the rights will be regarded as trading stock and deductible in terms of section 11(a).

PROHIBITED DEDUCTIONS

Payments for pollution will either be regarded as user charges or taxes as discussed earlier. Section 23(d) of the Income Tax Act, which prohibits the following deductions from income, can be divided into three parts, namely: (1) any tax, duty, levy, interest or penalty imposed under this Act (meaning the Income Tax Act (Clegg 1999:10-22)); (2) any additional tax imposed under section 60 of the Value-added Tax Act, 1991 (Act No. 89 of 1991); and (3) any interest or penalty payable as a consequence of the late payment of any tax, duty or levy payable under any Act administered by the Commissioner, the Regional Services Councils Act, 1985, and the KwaZulu and Natal Joint Services Act, 1990.

Discussion

Any payments for the use of the environment will probably not be affected by section 23(d), as these payments will probably be made in terms of a separate Act and not in terms of the Income Tax Act. If the Commissioner for the South African Revenue Service is also to administer the green charges or taxes, then any penalties and interest thereon will not be deductible.

RIGHTS

The expenditure incurred in acquiring marketable permits will in most cases be regarded as expenditure of a capital nature. Section 11(gA) of the Income Tax Act however allows a deduction in respect of expenditure incurred:

"(iii) in acquiring by assignment from any other person such patent, design, trademark or copyright or in acquiring any other property of a similar nature..."

Discussion

The issue here is whether marketable permits will be regarded as property of a similar nature to patents, designs and copyrights. Should that be the case, the purchaser of a marketable permit will be allowed to claim an allowance under section 11(gA). When the right is subsequently sold, there will be a recoupment under section 8(4)(a), being the recoupment of an allowance previously allowed.

Table 2: Summary of the income tax consequences for the paying party

Market-based instruments	General deduction formula	Capital allowance
Marketable permits	X	See discussion
Emission or effluent charges	✓	N/A
Product charges		
Fixed capital	X	✓
Floating capital	✓	N/A
Resource charges		
Fixed capital	X	✓
Floating capital	✓	N/A
Deposit-refund system		
Fixed capital	X	✓
Floating capital	✓	N/A
Two-tier charges	✓	N/A
Coupon system	✓	N/A
Administration charges	✓	N/A

VALUE-ADDED TAX CONSEQUENCES

The VAT consequences of green taxes and charges will depend on whether the payment is classified as a user charge or as a tax. The definitions of "enterprise" and "services" in the Value-Added Tax Act, No 89 of 1991 as amended are crucial as they will determine whether these payments will directly attract VAT. Traditionally user charges are for services provided by the state but which are also capable of being provided by the private sector. Electricity, the supply of water and the removal of sewerage and solid waste are examples of user charges. The above services are currently subject to VAT. The definition of "enterprise" in section 1 of the VAT Act includes as an enterprise:

- (b)(i) the making of supplies by any public authority of goods and services which the Minister, having regard to the circumstances of the case, is satisfied are of the same kind or are similar to taxable supplies of goods or services which are or might be made by any other person than such public authority in the course or furtherance of any enterprise, if the Minister under this subparagraph, has notified such public authority that its supplies of such goods or services are to be treated as supplies made in the course or furtherance of an enterprise;

- (c) in the case of a vendor which is a local authority, any activity in the cause or furtherance of which any of the following supplies of goods or services are made:
- (i) The supply of electricity, gas or water;
 - (ii) the supply of services consisting of the drainage, removal or disposal of sewage or garbage;..."

The definition of "services" means anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of "goods".

According to Deloitte and Touche (1997:18) virtually any type of economic activity which is not a supply of goods, could potentially be a supply of services. Huxham and Haupt (1994:31) interpret "the granting, assignment, cession or surrender of any right or the making available of any facility or advantage" to be of extremely wide application. Although the definition of services is extremely wide in its application, a media statement released by the Commissioner for Inland Revenue (1991) stated that public authorities performing social, administrative, control and legislative functions which are financed almost entirely out of state funds and are not carried on in competition with the private sector, are not required to register for VAT-purposes.

Discussion

The VAT consequences of green taxes and charges are more complex than the income tax consequences. The main issue is whether these payments will be regarded as user charges as the DEA&T propagates and will therefore be subject to VAT. Only user charges for services provided by the state, of the same kind or similar to taxable supplies of goods and services which are or might be made by any other person than such a public authority, are currently subject to VAT. If its services are subject to VAT, the government department or local authority should be registered for VAT purposes.

User charges for services rendered by the state, like water or electricity supplies and the removal of solid waste and sewerage, are currently subject to VAT. Any differential charges, by applying the two-tier charges system, with the intention of making the service provided by the state more expensive in some instances by charging different rates, will be subject to VAT.

The services of re-use, recycling, storage or destruction services envisaged by the deposit refund system will be regarded as the supply of services. These services can easily be provided by the private sector (therefore categorising the service as a user charge). It appears that any government department rendering such a service will

have to register for VAT purposes. The VAT consequences may be similar to the VAT treatment of returnable containers. The amount of any deposit payable to or refundable by a vendor in respect of a returnable container will be deemed to include tax (section 64(2) of the VAT Act). It is submitted that the deposits received will not be for the benefit of the National Revenue Fund as they are repayable when the goods are returned.

It can also be argued that an administration charge is similar to a user charge. VAT will only be levied on the administration charge if the revenue is not for the benefit of the National Revenue Fund, is payable to the DEA&T and the DEA&T is registered for VAT purposes. This type of charge appears to be similar to RSC levies which are currently subject to VAT.

It is unlikely that marketable permits, product and resource charges, emission and effluent charges and coupon charges can be considered to be user charges for services rendered by the state which are also capable of being provided by the private sector. However the definition of "services" in section 1 of the VAT Act is extremely wide in application and it may be argued that the right to pollute granted by marketable permits, emission and effluent charges and coupon charges fall into this category.

Green taxes are considered to be different. It does not matter which instrument is used, the revenue will fall into the state's coffers. No direct supply of services is provided when taxes are paid. Public authorities performing administrative and control functions which are financed almost entirely out of state funds are not required to register for VAT purposes (Commissioner for Inland Revenue 1991).

However, the main purpose of green charges or taxes is to make the price of the product or service more expensive. The same objective is achieved by the levying of customs and excise duty. Although customs and excise duties are not subject to VAT, both customs duty (in terms of section 13(2) of the VAT Act) and excise duty (in terms of section 7(3)(a) of the VAT Act) are added to the value of the goods for purposes of levying VAT and therefore indirectly attracting VAT. Product and resource charges can easily be incorporated into the excise duty system.

When a vendor makes a taxable supply of goods or services, the cost of the green charges or taxes paid will be incorporated into the price thereof. It can therefore be argued that the value of supplies, and subsequently also VAT, will increase. Although green charges or taxes will not be subject to VAT, the effect will be that VAT will be indirectly payable on them.

Table 3: Summary of the VAT consequences (Based on the assumption that government departments or local authorities will have to register for VAT purposes)

Market-based instrument	"Service" as defined and supplied by a "vendor"
Marketable permits Issued by state Sold by or purchased from vendor	See discussion ✓
Emission or effluent charges	X
Product charges	X
Resource charges	X
Deposit-refund system	✓
Two-tier charges	✓
Coupon system	X
Administration charges	✓

CONCLUSION

Income Tax

Green charges or taxes (excluding marketable permits and products that might be regarded as fixed capital) should be deductible for income tax purposes, as they are incurred in the production of income and are not of a capital nature. Marketable permits in most cases will be regarded as being of a capital nature and therefore not deductible in terms of the general deduction formula. There is a possibility that a section 11(gA) allowance may be claimed on a marketable permit, provided that it can be regarded as similar to patents, models, trademarks or copyrights. This issue should be clarified before marketable permits are implemented. It is submitted that section 23(d) will not prohibit the deduction of green charges or taxes. If the intention is not to allow green charges or taxes as deductions, then section 23(d) should be amended to clarify this fact.

Value-added tax

The VAT consequences of green charges or taxes are more complex than the income tax consequences and there are many issues that should be addressed before implementation. The following issues were identified, namely:

- Can the payment of green charges or taxes be regarded as payments for services rendered by the state?

- If so, will they be classified as a user charge, namely a service that is capable of also being provided by the private sector?
- Will the public authority rendering the service have to register for VAT purposes?
- How will the revenue from green charges or taxes be applied? For the benefit of the public authority to cover costs and environmental projects or as part of the National Revenue Fund?

Only user charges (for example the deposit-refund system, two-tier charges and administration charges) are capable of attracting VAT, which will only be levied if the public authority is making taxable supplies of goods and services, which are or might be made by any person other than the public authority and the public authority is registered for VAT purposes. If a marketable permit is subsequently sold by a vendor, it could be argued that a "service" as defined was rendered and that VAT is payable.

Green taxes are dealt with differently. Irrespective of the instrument used, the revenue from green taxes will fall into the state's coffers. No direct supply of services is provided when taxes are paid.

There is, however, no doubt that green charges or taxes will increase the value of goods and services and therefore indirectly increase the amount of VAT payable on the goods or services.

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