



The Notion of Human Capital Accumulation as a basis for reform of select employment related tax incentives in Kenya and South Africa

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ABSTRACT

Human capital signifies the idea that skills and capabilities embodied in human beings constitute a form of capital. The collection of human skills and capabilities i.e. human capital, in a country, represents the human capital accumulation in that economy. This human capital accumulation is achieved through a process of instilling, building up and developing skills and capabilities.

This dissertation considers use of tax incentives to contribute to human capital accumulation in Kenya and South Africa. Currently, there are some indirect tax incentives in both countries which give favourable treatment to some employee related expenses. There also exists, in both Kenya and South Africa, a direct employer tax incentive aimed at encouraging employment of graduates and specific job seekers. In both countries, however, there is no broad direct tax incentive that benefits all employers who contribute to developing various other forms of human capital.

The dissertation therefore looks at considerations and reforms which are necessary to establish a desirable tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation. Some of the considerations which the dissertation looks at include; why employers should be given the incentive, why the incentive should be direct, whether the existing tax incentives meet the goal of human capital accumulation and the relevance of human capital accumulation to Kenya and South Africa.

The dissertation also suggests some reforms that should be made in developing a desirable direct tax incentive for employers. The suggested reforms are based on deficiencies identified from an evaluation of the like direct employment incentive schemes offered by Kenya and South Africa to employers to encourage employment of graduates and specific job seekers.

GLOSSARY OF TERMS

ETI	Employment Tax Incentive.
ICT	Information and Communications Technology.
IT	Information Technology.
KITA	Kenya Income Tax Act CAP 476 Laws of Kenya.
R&D	Research & Development.
SEZ	Special Economic Zone.
SITA	South Africa Income Tax Act No. 58 of 1962.

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CHAPTER ONE

1. INTRODUCTION

1.1 *Background*

The terms ‘human capital’, ‘human capital accumulation’ and ‘human capital investment’ represent ideas. Thus, the terms do not supply meaning to themselves. This background expounds on the ideas underpinning the terms human capital, human capital accumulation and human capital investment.

Human capital denotes, ‘the collection of productive skills embodied in a person that can be used to generate earnings in the labour market and to augment household’s consumption options’¹. From an economic perspective human capital is the explanation for the difference between the high increase in national output against the minimal increase in land, labour input and physical capital². In essence, human capital constitutes the element of economic growth which cannot be traced to an increase in other factors of production like land or machinery.

On the other hand, human capital accumulation denotes the stock or pool of people comprising of professionals and entrepreneurs who provide skills in an economy³. Notably, a process is behind human capital accumulation. The process entails developing of human skill through teaching and other ways of instilling the human skill. Another important aspect of human capital accumulation is that the evidence of high human capital accumulation is its extent of spread throughout the market⁴. This is because human capital is found

¹Weiss Y, 'Gary Becker on Human Capital' 2015 (81) *Journal of Demographic Economics* p. 27, para 2.

² Schultz TW, 'Investment in Human Capital' 1961 (51) *The American Economic Review* p. 1, para 1.

³ Iyigun MF and Owen AL, 'Risk, Entrepreneurship, and Human-Capital Accumulation' 1998 (88) *The American Economic Review* p. 454, para 1 et. seq.

⁴ Galor O and Moav O, 'From Physical to Human Capital Accumulation: Inequality and the Process of Development' 2004 (71) *Review of Economic Studies* p. 1002, para 1.

in people, hence, the greater the spread of the capital among people the greater evidence there is of a high stock of human capital.

Lastly, investing in human capital is the undertaking of activities and spending of resources on a person which results in an increase in the future earnings of the person⁵. Investing in human capital is also termed as human capital development which entails improvement of an individual's knowledge and skills to realize a better output in the workplace or personal life⁶.

The three aspects of human capital, human capital accumulation and human capital investment are therefore interrelated. The interrelation is in that, the skills embodied within a person constitute human capital. These skills are created through a process of investment or development. Following the building up process, the pool or collection of people carrying these skills constitutes the 'trading stock' or human capital accumulation within an economy. The process of building up or developing the stock of human capital is central to human capital accumulation.

The dissertation makes use of each of these terms to build its argument. At the core, the dissertation is looking to consider how tax policy can be a means of contributing to this process of amassing human capital i.e. to human capital accumulation.

1.2 *Research question*

This dissertation seeks to examine the question, 'what are the considerations and reforms desirable to establish an ideal direct tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation?'

⁵ Becker GS, 'Investment in Human Capital: A Theoretical Analysis' 1962 (70) *Journal of Political Economy* p. 9 para 1.

⁶ Johanson RKA, Arvil V., *Skills Development in Sub-Saharan Africa* Skills Development in Sub-Saharan Africa p. 1 para 1 et. seq.

1.3 *Objective*

The aim of this dissertation is to consider reforms needed in Kenya and South Africa to create an ideal direct tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation. To achieve this objective the dissertation proceeds as per the structure provided below.

1.4 *Structure of dissertation*

This dissertation is structured as follows:

Chapter 2 will look at the notion of tax incentive and its potential for use to contribute to human capital accumulation in Kenya and South Africa.

Chapter 3 looks the landscape of Kenya and South Africa tax policy in use to induce employers' contribution to human capital accumulation.

Chapter 4 will consider the relevance of human capital and justification for a direct tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation.

Chapter 5 will with deal some considerations to be made in establishing an ideal direct tax incentive that contributes to human capital accumulation in Kenya and South Africa.

Chapter 6 will set out recommendations and proposals of the dissertation.

Chapter 7 is the concluding chapter.

1.5 *Limitation and assumptions*

This dissertation looks at tax incentives under the income tax regime only and not under other tax laws. Moreover, the dissertation focuses on direct tax incentives that may be given to employers and not to employees. The justification for proposing an employer focused tax incentive is discussed under chapter 4 of the dissertation. That said, it is noted that employees should also be able to obtain some tax incentive to invest into themselves. The employee side is however outside the scope of consideration in this dissertation save for a few illustrations that may be made that touch on employees.

1.6 Research method

The doctrinal research method will be used to answer the research question. This will entail an analysis of various primary legislation including, the Income Tax Act No. 58 of 1962 of the Republic of South Africa, the Kenya Income Tax Act CAP 476 Laws of Kenya and the Employment Tax Incentive Act No. 26 of 2013. The research also draws from findings made by various economists within the field of human capital.

CHAPTER TWO

2. THE NOTION OF TAX INCENTIVE AND ITS POTENTIAL FOR USE TO CONTRIBUTE TO HUMAN CAPITAL ACCUMULATION IN KENYA AND SOUTH AFRICA

2.1 *Introduction*

The chapter is comprised of two main parts. To begin with, the chapter looks at some general aspects of tax incentives. This will lay a foundation for the idea behind tax incentives. Next, it proceeds to look at some specific features that a tax incentive should possess to potentially contribute to human capital accumulation in Kenya and South Africa.

2.2 *General aspects of a tax incentive*

On the general aspects the chapter considers, firstly, what are tax incentives? Next it considers why tax incentives are used. Thirdly, it considers the role that tax incentives play in decision making by businesses. Lastly, it considers some general characteristics of an ideal tax incentive regardless of its purpose.

2.2.1 *What are tax incentives?*

A tax incentive is a provision that accords special tax treatment to a specified group of people or a specified type of transaction⁷. This treatment is special in that, it is a deviation from the general tax treatment accorded to similar people or transactions⁸. In effect, the special tax provision would result into a lower tax burden than would ordinarily apply. Tax incentives take various forms including, tax credits, accelerated depreciation and favourable tax treatment for certain expenditures⁹. Other additional types of incentives include tax holidays and preferential tax zones like Special Economic Zones¹⁰.

⁷ Group WB, *Options for low income countries' effective and efficient use of tax incentives for investment : a report to the G-20 development working group by the IMF, OECD, UN and World Bank* (2015) p. 8 para 1 et. seq.

⁸ Ibid.

⁹ Easson A and Zolt EM, *Tax incentives* World Bank Institute 2002) p. 2 para 1.

¹⁰ Ibid.

It will also be worth mentioning that, in some cases it might not be very clear whether a tax treatment is an incentive or a form of ordinary tax treatment¹¹. An example would be, where a country lowers the applicable tax in an aspect like transfer of intellectual property. Further assume that, the lower tax rate in such a case is set to apply for all people making such a transfer of intellectual property. In such a case it would not be clear whether this is a form of incentive or just an ordinary tax treatment. The reason being that such a treatment would be ordinary in the sense that it applies to all people making such a transfer. On the other hand, it would be special in that the applicable rate on the transfer of that particular asset is lower, compared to a transfer of other assets.

Due to the possible lack of clarity, like in the illustration given, looking at the form of tax treatment might not always indicate clearly whether a tax treatment is an incentive or not. Hence, it might also help to look at the effect of the tax treatment. This is because the effect of a special rule, in most instances, is that it reduces the tax burden that would have been borne 'but for' the rule¹². Additional considerations like, the extent of the rule's deviation from common accounting treatment and deviation from general tax principles might also serve to indicate whether it is an incentive¹³.

2.2.2 *Why are tax incentives used?*

As regards use, governments use tax incentives as a tool to achieve different policy goals¹⁴. It is, indeed, a common practice for governments to use tax incentives to influence economic growth¹⁵. The policy goals that governments may seek to achieve through use of tax incentives are divergent and vary from country to country.

¹¹ UN-DESA and CIAT, *Design and Assessment of Tax Incentives in Developing Countries* (2018) *United Nations*, p. 6 para 1.

¹² See note. 11 p. 6 para 2 et. seq.

¹³ Surrey SS, 'Tax incentives as a device for implementing government policy: a comparison with direct government expenditures' 1970 *Harvard Law Review* p. 706 para 2 et. seq.

¹⁴ See note. 11 P. 5 para 2.

¹⁵ See note. 11 p. 3 para 2.

In general, tax incentives are an appealing tool for governments to deal with its economic needs¹⁶. Globalisation is a common need that would impact decisions of a majority of governments' since it causes countries to compete against each other to attract mobile capital from multinationals¹⁷. Trade liberalization further enhances competition among countries since businesses are able to segregate their operations over different locations¹⁸. As a result, governments find it attractive to use tax incentives as a way of drawing owners of such mobile capital to their countries.

Another common reason why most governments use tax incentives is it to influence positive spill over effects into the internal economy¹⁹. Tax incentives given for Research and Development (R&D) are one such example. Such incentives are aimed at, not only benefiting the R&D firm, but also at spilling knowledge into the market²⁰.

Governments also use tax incentives as a tool to spur development in underdeveloped parts of a country²¹. An example of an incentive aimed at spurring development is where a lower rate of tax applies for investing a specified amount in specified areas within a country. In essence, governments give such an incentive to provide a monetary benefit or monetary assistance with the goal of making investment in areas that are less enticing attractive²². Arguably, governments avoid direct spending by using tax incentives to encourage development of some areas by private individuals. Thus, tax incentives hold some appeal for the government as the government foregoes direct spending.

¹⁶ See note. 13 p. 713 para 2 et. seq.

¹⁷ OECD, *Corporate Tax Incentives for Foreign Direct Investment* 2001) p. 19 para 3.

¹⁸ Morisset J, 'Tax incentives: Using tax incentives to attract foreign direct investment' 2003. P. 2 para 1 et. seq.

¹⁹ See note. 17 p. 19 para 5 et. seq.

²⁰ Ibid.

²¹ See note. 17 p. 20 para 4.

²² See note. 13 p. 713 para 2 et. seq

Overall, tax incentives are an attractive tool for governments to use as a reaction to both internal and external needs. Use of tax incentives to influence human capital accumulation is therefore a viable option for the governments of Kenya and South Africa. Arguably, the rationale behind granting tax incentives for R&D i.e. to create positive externalities in the market is like what a tax incentive on human capital investments would aim to achieve²³. This is because the human capital developed through the incentive will circulate within the economy and benefit the economy as a whole.

While tax incentives are a possible tool for the government to use to pursue policy goals in the economy, the question that arises is whether they play any role in decision making by businesspeople. The next section considers this.

2.2.3 *What role do tax incentives play in business decisions?*

It is important to state at the outset that studies are not able to fully quantify which investments would not have been made ‘but for’ the incentive²⁴. Hence, studies do not agree on whether tax incentives achieve their intended goal. Nonetheless, tax incentives remain a popular factor in decision making by businesses for several reasons²⁵.

In the first place, the generous incentives that some countries offer to investors are irresistible²⁶. Hence businesses tend to be attracted to invest in countries which offer such generous incentives²⁷. Furthermore, tax incentives tend to influence investment decisions of multinationals since multinationals can exploit different tax regimes in their tax planning²⁸. Coupled with this, trade liberalization which has resulted in reduction of non-tax barriers makes tax a factor in choosing a location for multinationals²⁹. Additionally, tax incentives increasingly play a role in decision making for businesses looking to invest

²³ Costa R, Datta N, Machin S and McNally S, *Investing in People: The Case for Human Capital Tax Credits* (2018) p. 2 para 2.

²⁴ See note. 11 P. 4 para 1.

²⁵ See note. 18 p. 1 para 3.

²⁶ See note. 11 p. 6 para 3.

²⁷ See note. 18 p. 2 para 4 et. seq.

²⁸ See note. 18 p. 2 para 3 et. seq.

²⁹ See note. 11 p. 7 para 2 et. seq.

within a trading bloc³⁰. This is because regional trading blocs like free trade areas, customs unions and common markets put the countries within these areas in sharp competition for investments³¹. Another substantial area that tax policy influences business decisions is with regard to methods that businesses adopt for profit repatriation from a host country³². Ordinarily, tax incentives that favour repatriation of profits at a low tax cost will be attractive to businesses. Moreover, change in business behaviour where operations may be segregated through different locations makes tax considerations paramount in picking a business location³³. One can therefore argue that tax considerations have some influence on business decisions.

Important to note however is that tax incentives cause distortion in business decisions. The various distortionary effects are considered further below. Notably, these distortionary effects are a major criticism levelled against tax incentives³⁴. This is because the distortion caused is undesirable as it negatively affects the principles of a good tax system³⁵. As noted, before, however, despite their distorting effects tax incentives remain an appealing tool for use by governments. Acknowledging that tax incentives are likely to remain in use, several studies make proposals on characteristics that tax incentives ought to have to mitigate some of their distortionary effects. The next section considers some of these proposals which are meant to create an ‘ideal’ tax incentive.

2.2.4 *General characteristics of any ideal tax incentive*

In general tax incentives ought to fall in line with principles of taxation³⁶. The fundamental principles of a good tax system are fairness, neutrality, efficiency,

³⁰ Ibid.

³¹ See note. 11 p. 7 para 1 et. seq.

³² See note. 17 p. 27 para 1.

³³ See note. 11 p. 7 para 2 et. seq.

³⁴ See note. 13 P. 725 para 1.

³⁵ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report* (2015) p. 20 para 1.

³⁶ Group WB, *Options for low income countries' effective and efficient use of tax incentives for investment : a report to the G-20 development working group by the IMF, OECD, UN and World Bank* (2015) p. 6 para 2.

certainty, and simplicity³⁷. A properly designed tax incentive should therefore not lead to ambiguities, unfairness, or inefficiencies as these would be contrary to the fundamental principles.

That noted, tax incentives have the potential to carry several effects that are contrary to the fundamental principles of taxation³⁸. Some of such potential adverse effects include, erosion of tax base, abuse by free riders, failure to achieve their intended objectives³⁹, encouraging corruption and distortion of resource allocation⁴⁰. These adverse effects form the largest basis of criticism of tax incentives⁴¹. An effect like abuse by free riders, for instance, would result in unfairness to other businesses within the tax system which out rightly contravenes the fundamental principle of fairness. On the other hand, corruption would affect fairness, efficiency, and certainty in the application of tax incentives. All these potential effects of tax incentives working within a tax system are undesirable.

Some essential features that an incentive should possess to avert some of the potential distortionary effects include transparency, practical effectiveness, considerations on design and evaluation as well as cost effectiveness. Each feature is looked at below.

2.2.4.1 Transparency

Tax legislation should clearly stipulate the terms of a tax incentive⁴². Some of the terms that the tax legislation could provide for are; a clear definition of the

³⁷ NETO LF, *Addressing the Tax Challenges of the Digital Economy, Action 1-2015 Final Report* (2015) OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, p. 20 para 1.

³⁸ Clark S, Cebreiro A and Böhmer A, 'Tax Incentives for Investment—A Global Perspective: experiences in MENA and non-MENA countries' 2007 *MENA-OECD Investment Programme* p. 230 para. 1 et. seq.

³⁹ See note. 36 p. 6 para 3.

⁴⁰ Jun J, *Tax incentives and tax base protection in developing countries* (2017) *United Nations Economic and Social Commission for Asia and the Pacific (ESCAP)*, p. 1 & p. 2.

⁴¹ See note. 11 p. 3 para 1.

⁴² Zee HH, Stotsky JG and Ley E, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' 2002 (30) *World Development* p. 1502 para 2 et. seq.

special tax provision, the target group for the incentive, how the target group may access the incentive and necessary terms needed to give it effect.

Of note, lack of transparency in the administration of tax incentives is a main source of corruption⁴³. Corruption, in itself, is a non-tax barrier to investment hence, it is counterproductive for a country to use tax incentives if they lead to corruption⁴⁴. To reduce such cases of corruption from lack of transparency, the terms of the incentive should be simple, clear, and certain. Moreover, official administrators within the government department should not have the discretion to apply or subjectively interpret provisions that encompass tax incentives⁴⁵. Arguably, such discretion gives room for uncertainty and opaque practices. If, however, there is room for exercise of discretion there could be documentation showing those who are enjoying the incentive and the reasons for granting it to them. That way, some obvious causes of uncertainty and corruption which might affect transparency will be addressed.

2.2.4.2 Practical effectiveness

A tax incentive should not be a disguise to cover up a bad tax law or to seal a gap that exists in a legislation⁴⁶. In some cases, the drafting of a tax law might restrict certain benefits excessively. An example would be in the case where a tax legislation unnecessarily restricts deduction of expenses that an employer incurs for the benefit of employees. In such a case, the practical solution would be to change the existing legislation to allow such deductions rather than grant a tax incentive to deal with such restrictions.

In the same light, other economic factors might be behind the negative effect that the tax incentive seeks to rectify⁴⁷. For instance, labour laws could be the reason for slow human capital accumulation due to provisions dealing with matters like retrenchment. A provision on retrenchment could affect human

⁴³ See note. 42 p. 1502 para 1.

⁴⁴ See note. 11 P. 17 para 3.

⁴⁵ See note. 42 p. 1502 para 6.

⁴⁶ See note. 42 p. 1499 para 3 et. seq.

⁴⁷ See note. 42 p. 1499 para. 4 et. seq.

capital accumulation through discontinuing use of human skills. A tax incentive may therefore not obtain the desired benefit if the other laws work against the objective of the incentive.

It would, thus, be important to consider other factors in the environment that would impede the objective sought by the tax incentive and address them⁴⁸. In the case of human capital accumulation, for instance, social factors may also affect human capital accumulation. Social factors might include cultural values that have an impact on employment based on gender, religion and such other social aspects. To achieve practical effectiveness from a tax incentive, it might thus be necessary to implement reforms in social norms.

2.2.4.3 Design and evaluation

If properly designed, a tax incentive has the potential to benefit the economy by attracting foreign investment and imparting positive spill over effects into the internal market⁴⁹. Design entails a number of things but would comprise; setting the goal, narrowing down the target and determining the type of incentive to grant⁵⁰.

A well-designed tax incentive should have a clear goal in mind and should target to achieve this clear goal⁵¹. Moreover, the end goal sought by the incentive should be desirable meaning that it should be an end which would not be achieved but for the incentive⁵². This means that there should be a specific and goal-oriented purpose for introducing an incentive. To achieve this, some relevant considerations would need to be taken into account in the design⁵³. Later, the dissertation discusses some considerations which are relevant in the case of human capital accumulation. By way of highlight however, some relevant considerations include which employers would be best placed to contribute to human capital accumulation? What would encourage such

⁴⁸ Ibid.

⁴⁹ See note. 11 P. 13 para 2.

⁵⁰ See note. 11 p. 20 – p. 22.

⁵¹ See note. 42 p. 1500 para. 6.

⁵² See note. 11 P. 20 para 1 et. seq.

⁵³ See note. 42 p. 1500 para. 6.

employers? What sectors should the incentive target? That said, the country specific needs should advise the considerations for granting any incentive taking into account political, economic and social factors⁵⁴.

As regards being focused on a goal, an incentive could target either a sector or a location which would help to narrow down misuse of the incentive⁵⁵. Notably, misuse of tax incentives is as a common cause of inefficiencies⁵⁶. Misuse could come about through various ways like, aggressive tax planning or free riders taking advantage of the incentive without meeting the desired goal of the incentive. As regards evaluation, the aim would be to determine the incremental investments following the introduction of the investment as against the cost of the incentive⁵⁷. As part of evaluation, the government could set a cap on the cost of a tax incentive. This will help the government to monitor the costs that accrue from the tax incentive.

2.2.4.4 Cost effectiveness

The revenue foregone by the government, administration costs and other indirect costs like distortion of investments, tax leakages and corruption constitute costs of a tax incentive⁵⁸. Another common cost associated with tax incentives is what is termed as ‘the race to the bottom’⁵⁹. A race to the bottom happens within a regional trading block where governments feel pressured to give more and more incentives to attract investments to their countries. While it is not an automatic cost, it is largely a potential risk since the competition may cause governments to go off in this tangent of racing to the bottom.

Due to these attendant and potential costs, the government should ideally not grant an incentive where the activity sought to be encouraged would have been

⁵⁴ Jun J, *Tax incentives and tax base protection in developing countries* (2017) *United Nations Economic and Social Commission for Asia and the Pacific (ESCAP)*, p. 3 para. 3.

⁵⁵ See note. 11 P. 21 para 1 et. seq.

⁵⁶ Rumina UA, Balandina AS and Bannova KA, 'Evaluating the Effectiveness of Tax Incentives in Order to Create a Modern Tax Mechanism Innovation Development' 2015 (166) *Procedia - Social and Behavioral Sciences* p. 159 para 3.

⁵⁷ P. 18 para 3.

⁵⁸ See note. 42 p. 1501 para. 3.

⁵⁹ See note. 18 p. 3 para 3.

undertaken without the incentive⁶⁰. Thus, in an ideal situation a tax incentive should only be granted to exclusively achieve a desired objective i.e. one which would not have been achieved but for the incentive. This approach would cut on misuse of the incentive by free riders. That said, in reality this is difficult to achieve⁶¹.

In the case of human capital accumulation, for instance, since an employer would engage employees without an incentive it might not be clear who might be free riders. This difficulty may, however, be addressed through other techniques outside the tax system which may be applied to monitor the realization of the objective. Some such possible techniques would be a requirement to develop certain skills, stipulation of minimum time period to engage an employee or accreditation of employers who have contributed to the objective. Essentially, such a design will task employers to expend effort to obtain the incentive hence help to discourage free riders.

Having considered the above general features that would make any tax incentive ‘ideal’ the chapter now turns to consider what would be some specific aspects for tax incentive to be ‘ideal’ for human capital accumulation.

2.3 Specific aspects of a tax incentive that contributes to human capital accumulation

On the specific aspects, the chapter considers two things. In the first place, what features should a tax incentive possess to make it appealing to employers in Kenya and South Africa? Subsequently, it considers what would constitute a successful tax incentive from the standpoint of the government’s goal of spurring human capital accumulation.

2.3.1 What characteristics would make a tax incentive appealing to employers?

⁶⁰ Ibid.

⁶¹ See note. 13 p. 720 para 1.

Arguably, for an incentive to appeal to employers it will need to address concerns that follow from investing in employees. Some of the concerns that may be considered in the design are discussed below. Note however that the list of possible concerns is not presented as exhaustive.

2.3.1.1 Mitigation of risk

Investment into developing human capital is a risky type of investment⁶². This is because an employer spends significant time and resources on employees who have the freedom to change employers at will⁶³. Some employers have invented ways of retaining employees in whom they have invested significant training by requiring them to work for a period⁶⁴. Arguably, such an option it is available for employers who have the capacity to negotiate such terms. Hence, such an action does not fully mitigate the risk for all employers. Moreover, such a restrictive practice acts to prevent the movement of skills within the economy which movement is not entirely undesirable⁶⁵.

From the perspective of risk, granting a tax incentive may act to encourage employers to invest in human capital if it can mitigate the risk of investment⁶⁶. Of note, in the past employees mostly stayed with a single employer for their entire working life which is a rare occurrence in modern times⁶⁷. This change in the work culture has made employers less keen on investing in their employees today⁶⁸. As a result of employers taking a step back from investing in employees the economy is deficient of highly skilled workers⁶⁹.

Notably, the loss suffered when an employee changes employer is on the ‘developer’ of the employee i.e. the investing employer but since the skills are retained within the economy, it is not real a loss. Hence, the individualistic approach that employers are taking in not investing in their employees is

⁶² See note. 23 p. 2 para 1

⁶³ See note.23 p. 2 para. 3.

⁶⁴ See note.23 p. 10 para 2

⁶⁵ See note. 23 p. 10 para 2 et. seq.

⁶⁶ See note. 23 p. 10 para 1 et. seq.

⁶⁷ Fitzpayne A and Pollack E, 'Worker Training Tax Credit' 2017 *Aspen Institute* p. 2 para. 4.

⁶⁸ See note. 67 p. 2 para 4 et. seq.

⁶⁹ See note. 67 p. 2 para 5.

eventually a cost to the economy⁷⁰. An ideal tax incentive should therefore encourage development of human capital, not with the view of an employer hoarding the skill, but with the aim of the skill creating a positive externality in the economy⁷¹. The tax incentive would serve as a form of compensation to the employer by the economy which gains from the employer's effort⁷².

2.3.1.2 Taking into account the capacity of an employer to invest

Small and medium sized businesses tend not to invest substantially in their employees due to capital constraints⁷³. Moreover, the risk of loss that such firms would suffer for training and losing employees is much higher compared to bigger firms⁷⁴. Additionally, loss of employees is less common to larger firms since they tend to pay higher wages and thus have potential to retain their trained employees⁷⁵. Smaller firms on the other hand tend to pay less than the bigger firms hence, they tend to lose the employees who they train to the better paying firms. A tax incentive designed for smaller firms could help to address the problem of capital constraints and mitigate on the risk of loss. On the other hand, the design of the ideal incentive could require more from the larger firms in terms of the amount of investment that such firms should make into their employees.

While these are some of the concerns that employers might have, it is also important to consider what would make an incentive successful from the perspective of the government.

2.3.3 What would a successful tax incentive look like from the government's perspective?

⁷⁰ See note.67 p. 2 para 5 et. seq.

⁷¹ See note. 17 p. 3 para 1.

⁷² See note. 17 p. 3 para. 1.

⁷³ Lerman RI, McKernan S-M and Riegg S, 'The scope of employer-provided training in the United States: Who, what, where, and how much?' 2004 *Upjohn Institute Publications* p. 212 para 2 et. seq.

⁷⁴ See note. 73 p. 215 para 1 et. seq.

⁷⁵ Ibid.

Notably, businesses do not ordinarily need an incentive to employ workers since they need people to operate. Furthermore, through employment employees learn practical skills from exposure to the work environment. That said, human capital accumulation should ideally also be strategic to address skill gaps existing in a market. Hence, mere employment along the needs of a business would be inadequate to create a sufficiently equipped pool of human capital. This is because some critical skills may remain undeveloped. Based on this understanding, the government's interest should come into play since it would be in its interest that the economy grows.

From a government's perspective therefore, the design of the tax incentive should be strategic in addressing issues of, among others, underinvestment, skewed investments, and lack of investment in some sectors⁷⁶. This being the case, a tax incentive aimed at contributing to human capital accumulation would be successful if it is strategic in some of the ways discussed below. It is important to note, however, that the list of strategic ways to design the incentive is not exhaustive, rather it is indicative of some considerations that should be borne in mind.

2.3.3.1 An incentive strategically aimed at even distribution of investments

In general, employers are more likely to invest in the highly skilled workforce than in the lower cadre of employees if the decision to invest is at their discretion⁷⁷. The tax incentive could resolve this by aiming at obtaining an even distribution in the investment into employees. The incentive could do this by granting different amounts of tax benefits for investment into different classes of employees.

2.3.3.2 An incentive strategically targeted at certain sectors

This could entail targeting development of skills within a sector. For instance, the sectors of the economy that require technical changes tend to train

⁷⁶ See note. 67 p.1 para 1 et. seq.

⁷⁷ See note.67 p. 3 para 1.

employees continually to implement the necessary changes⁷⁸. Significant human capital investment is therefore needed by a firm implementing technical changes continually to deal with obsolescence of existing skills or to develop existing skills⁷⁹. Technical changes in this case could range from changes imposed by regulations to changes necessitated by the market. For instance, companies operating in sectors that are heavily reliant on technology experience rapid changes in technology thus there is continuous need to invest in human skills to equip them to deal with the new technology⁸⁰.

Arguably, a tax incentive aimed at these sectors would have a good uptake and would be a tangible support given by the government to these sectors. Additionally, such an incentive would encourage advancement in technology within the economy. Observably, the outworking of an incentive in these ways should be a win for the governments.

2.4 *Conclusion*

The chapter has looked at the general aspects of tax incentives. It defined a tax incentive, considered why tax incentives are used and the role that incentives play in making of business decisions. Under the general aspects the chapter considered the characteristics of any ideal tax incentive that aims at avoiding distortion of the principles of taxation. As regards the specific aspects the chapter looked at some considerations that would make a tax incentive appealing to employers. Subsequently, the chapter looked at some features of a tax incentive that would make it successful from the government's perspective.

⁷⁸ See note. 73 p. 215 para 2.

⁷⁹ Bartel AP and Sicherman N, 'Technological change and the skill acquisition of young workers' 1998 (16) *Journal of Labor Economics* p. 719 para. 2.

⁸⁰ See note. 79 p. 748 para 1.

CHAPTER THREE

3 LANDSCAPE OF KENYA AND SOUTH AFRICA TAX POLICY IN USE TO INDUCE EMPLOYERS' CONTRIBUTION TO HUMAN CAPITAL ACCUMULATION

3.1 *Introduction*

This chapter considers the current use of tax policy by Kenya and South Africa to induce human capital accumulation through contributions made by employers. To this end, the chapter considers two aspects. First, it will highlight some indirect tax incentives that are benefitting employers in Kenya and South Africa. Next, it will show that a direct employer incentive which contributes to human capital accumulation would be different from the highlighted indirect incentives. Subsequently, the chapter will show that there exist insufficient direct tax incentives to encourage employers to invest in their employees.

3.2 *Some indirect incentives benefiting employers in Kenya and South Africa*

There exist indirect tax incentives both in Kenya and South Africa which benefit employers in some ways. These indirect incentives take various forms. In South Africa, for instance, the research and development incentive allow a taxpayer to claim a deduction of 150% of the expenditure actually incurred in respect of carrying out research and development⁸¹. This incentive would benefit an employer involved in the research and development indirectly by allowing a deduction of employee related costs actually incurred for that purpose. Moreover, South Africa has a Special Economic Zones regime where people who set up in these zones enjoy certain tax benefits. Employers operating within these special economic zones receive certain benefits for costs incurred on employees like deduction of training costs for the furtherance of industrial

⁸¹ Section 11D of the SITA provides for the deduction of the actually incurred directly and solely for research and development upon meeting the set conditions.

policy⁸². Similarly, in Kenya, entities that are set up in Special Economic Zones (SEZ) enjoy a reduced corporate tax rate⁸³. Employers within the SEZ would benefit indirectly from the incentive since they pay a lower tax on non-deductible costs incurred on employees. Noteworthy, there are other tax incentive schemes in Kenya that might benefit employers indirectly.

While the benefit of these incentives to employers can be identified, the next section shows that any contribution made to human capital accumulation through them is more secondary than primary. This is because the beneficiaries of these indirect incentives are not primarily meant to be employers. Rather, the incentives only benefit an employer who happens to find themselves within the primary boundaries of the indirect incentive.

3.3 How different are the indirect incentives from a direct employer incentive that contributes to human capital accumulation?

A direct tax incentive would specifically aim at encouraging investments which employers make to develop human capital. Such an incentive would be direct in the sense that, an employer would enjoy it because they meet a set criterion of investing or developing their employees. This is as opposed to an employer obtaining a benefit relating to employees because of other circumstances like location of their business in a special economic zone. Thus, the fact that an indirect incentive contributes to human capital accumulation is secondary while a direct incentive would have this as its primary goal. Moreover, the indirect incentives are not for use by all or any employers, but the primary target of the incentive would be other people who in this case also happen to be employers.

An illustration of a direct tax incentive is the tax rebate granted on recruitment of graduates in Kenya based on section 39B of the Kenya Income Tax Act. In the case of South Africa, the Employment Tax Incentive scheme granted to

⁸² Section 12I (5) of the South African Income Tax Act, No. 58 of 1962.

⁸³ Based on paragraph 2(h) of the Third Schedule to the KITA, entities set up in a SEZ are subject to corporation tax at the reduced rate of 10% for the first 10 years which increases to 15% for the subsequent 10 years.

employers under the Employment Tax Incentive Act No. 26 of 2013 would be a similar type of direct employer tax incentive.

Overall, the indirect incentives are pursuing other government priorities and not human capital accumulation. This thesis proposes the use of a direct tax incentive like the tax rebate in Kenya and the Employment Tax Incentive in South Africa to spur human capital accumulation. As will be shown in the next chapter, pursuit of human capital accumulation should be a primary goal of the governments of Kenya and South Africa. That noted, the next section considers tax legislation in Kenya and South Africa to show that the tax legislation also fails to provide such a sufficient direct incentive to employers so as to encourage them to invest in developing human capital.

3.4 *Sufficiency of existing direct tax incentives for employers*

This part will first look at whether, and the extent to which, deduction of employee related expenses for tax purposes constitutes a direct tax incentive for employers in Kenya and South Africa. Then, it will consider the outworking of the direct employer incentives schemes operating in Kenya and South Africa to determine if they are a sufficient incentive for employers.

3.4.1 *Kenya*

3.4.1.1 *Tax treatment of employee related expenses incurred by employers*

Based on the Kenya Income Tax Act (KITA), an employer may deduct expenses relating to employees in computing their taxable income⁸⁴. These would be expenses that are expressly provided for deduction under section 15 of the KITA if they are incurred wholly and exclusively in the production of the income in question. By interpretation, expenses which are not expressly listed under section 15 may also be deducted if incurred wholly and exclusively for the

⁸⁴ Mutava C, 'Kenya, Corporate Taxation sec. 1.' 12 February 2019 *Country Analyses IBFD* p. 8 para 1 et. seq.

production of the income in question. As a rule, capital expenditure is not an allowable expense unless the law expressly provides for deduction⁸⁵.

Employee related expenses which are expressly listed as deductible under section 15 of the KITA include, contributions made to a registered retirement benefits scheme, club subscriptions paid on behalf of employees, business related training costs and medical expenses including medical insurance costs. Moreover, based on section 15, the value of non-cash benefits provided to employees like expenses incurred on business trips and meals provided to employees of a limited monetary value are deductible. As a rule, expenses which are taxable on an employee would be an allowable expense for the employer⁸⁶. For instance, insurance premiums paid on the lives of the employees or their dependants are deemed to be income taxable on the employee and therefore are deductible by an employer.

While noting most expenses incurred on employees are ordinarily allowable, some expenses are disallowed as tax deductible expenses for the employer. This restriction is as provided under section 16 of the KITA. Some of such disallowable expenses listed under section 16 include, education fees paid on behalf of employees or their dependants, pension contributions made for employees in excess of the specified limit and vacation expenses except for leave passages paid on behalf of expatriates engaged by the employer.

Moreover, by interpretation, any expenses incurred on employees which are not wholly and exclusively related to the production of the income under consideration would be disallowed. The ‘wholly and exclusive’ term would mean that many expenses that have both an element of personal benefit and business benefit would not be tax deductible. As a result, the law would disallow training and education expenses that are outside the scope of the business activities of an employer. By way of example, the law does not allow deduction

⁸⁵ See note. 84 p. 7 para 13.

⁸⁶ See note. 84 p. 8 para 1 et. seq.

of costs of generic education courses like a Master's in Business Administration despite the relevance of the skills to a business.

The deduction of employee related expenses against taxable income of an employer is not peculiar. Under the Haig-Simon's concept, income is the difference between the wealth at the beginning and the wealth at the end of the period⁸⁷. The aggregate wealth at the end of a period is however reduced by the amount of consumption during the period, that is, expenses incurred⁸⁸. The tax legislation regulates the amount of consumption that is deductible for tax purposes. This is to ensure that a person does not claim every manner of consumption resulting into a low taxable income. But this does not mean that expenses which are deductible for tax purposes constitute a special kind of treatment. Rather, as a rule, expenses incurred to produce taxable income should be deductible in computing the taxable income⁸⁹. On this basis, business related expenses incurred for purposes of producing the taxable income are, rightfully, be deducted in computing the taxable income.

Hence, this deduction of expenses in Kenya is not a form of special rule i.e. a tax incentive to the employer. Rather, it entails operation of the income tax computation as it should be. This noted, the next section considers the extent to which the tax rebate granted on employment of employees based on section 39B of the KITA suffices as an incentive for employers to invest in human capital.

3.4.1.2 Tax rebate on employment of graduates

The Finance Act 2015 passed an amendment to the KITA by introducing section 39B which allows employers to claim a tax rebate for engaging university graduates as apprentices. The Income Tax (Set-off Tax Rebate for Graduate

⁸⁷ Bittker BI, 'Income Tax Deductions, Credits, and Subsidies for Personal Expenditures' 1973 (16) *The Journal of Law Economics of Education Review* p. 195 para 2.

⁸⁸ Ibid.

⁸⁹ Brodsky S and McKibbin D, '- Deduction of Non-Trade or Non-Business Expenses' - *Tax Law Review* p. 39 para 1 et. seq.

Apprenticeships) Regulations 2016 stipulate the conditions for use of the incentive. Based on the Regulations the rebate is given on condition that, a person engages at least 10 university graduates. Additionally, the apprenticeship agreements with the graduates should be registered with the National Industrial Training Authority. Moreover, the engagement should be for a period of 6 to 12 months.

Section 39B of the KITA provides the tax rebate to qualifying employers which takes the form of an additional deduction of expenditure equivalent to 50% of the salaries and wages paid to the apprentices. In essence, the employer is allowed a 150% deduction of salaries and wages paid to apprentices. Notably, the structure of the tax rebate makes it a form of a tax incentive. This is because it is a special rule that grants a special deduction which would ordinarily not be available to employers under the ordinary tax legislation⁹⁰.

To an extent, this tax rebate contributes to human capital development. This is to the extent that it serves to provide graduates with an opportunity to perfect skills taught in school and to obtain other skills from on-job training⁹¹. Nonetheless, the rebate does not go further in developing human capital. This is because the incentive is narrow in scope because its aim is to accomplish the single purpose of increasing absorption of graduates into the market. The narrow focus is however as intended seeing that its sole aim is to encourage employment of graduates.

Noteworthy, no study results have been found, at the point of writing this dissertation, showing the impact that the tax rebate has had on increase of employment of graduates. Looking at the structure of the rebate however, the rebate is likely to encourage employment of graduates by small businesses for whom a deduction of the additional 50% expense would have an impact. However, for bigger businesses with much higher revenues the 50% additional

⁹⁰ See note. 13 p. 706 para 1 et. seq.

⁹¹ See note. 5 p. 11 para 1.

expense claim may not have much of an impact. Hence, the rebate may not be a big incentive for bigger businesses. Furthermore, arguably, the amount of rebate is significantly low compared to the training offered to equip graduates with practical skills by both small and big businesses.

Overall, the tax rebate as an incentive is narrowly structured to target absorption of graduates into the market. The thesis acknowledges that this has a positive impact on initial development of human capital through offering practical skills to graduates. The rebate however does not target other categories of labour since this is not the objective of the tax rebate incentive. As a result, a gap remains in Kenya on direct tax incentives available to encourage employers to develop their employees.

3.4.2 *South Africa*

3.4.2.1 *Tax treatment of employee related expenses incurred by employers*

The primary legislation that deals with tax in South Africa is the Income Tax Act, 58 of 1962 (SITA). Expenses incurred on employees are allowed as a taxable deduction to the extent provided under the SITA. Accounting principles would not apply to deal with any expenses not expressly allowed as deductions under the SITA⁹². Of note, several provisions in the SITA apply in determining deductible expenses for tax purposes.

The provisions dealing with deductions are in two categories. The categories consist of the, 'general deductions formula' and the 'specific deductions formula'. The general deductions formula applies as a filter for any factual situation to determine whether the expense should be deducted⁹³. The specific

⁹² Hattingh PJ, 'South Africa - Corporate Taxation sec. 1, ' 1 April 2019 *Country Analyses IBFD*. P. 5 para 2 et. seq.

⁹³ See note. 92 p. 6 para 2 et. seq.

deduction formula, on the other hand, is provided under a particular section of the SITA and applies if all the criteria provided under the section is met⁹⁴.

The two sections that lay out the general deductions formula are section 11(a) and 23(g) of the SITA. Section 11(a) sets out the positive test for deduction of expenses. Based on section 11(a), in determining the taxable income, a person can deduct expenses and losses that are actually incurred in the production of income with the exception of capital expenses. This section therefore lays the basis for deduction of expenses incurred on employees in the production of income.

Section 23(g) of the SITA, on the other hand, lays out the negative test. Based on section 23(g) a person should not deduct 'any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade'. Essentially, expenses incurred on employees for production of income must also be incurred for purposes of trade for them to be deductible.

Like any other expenses, employee related expenses would need to be weighed against these two tests i.e. the positive and the negative deduction tests. This is with the exemption of any expenses which the SITA specifically allows as deductions, like, payments with respect to restraint of trade⁹⁵. Ordinarily, however, costs incurred by an employer under an employment contract would be deductible⁹⁶. Thus, costs like salaries and wages, voluntary bonuses, non-cash benefits like cost of meals, social security contributions and pension contributions payable on retirement would be deductible⁹⁷. However, the deduction of some employee related costs like insurance premiums on the life of employees and their dependants may be problematic⁹⁸.

⁹⁴ See note.92 p. 6 para 3 et. seq.

⁹⁵ Section 11 c(A) of the Income Tax Act, No. 58 of 1962.

⁹⁶ See note.92 p. 47 para 7 et. seq.

⁹⁷ Seventh Schedule to the Income Tax Act, No. 58 of 1962.

⁹⁸ See note. 92 p. 48 para 1 et. seq.

That noted, there is a distinction between tax incentives laid out in special tax rules and the normal outworking of a tax structure⁹⁹. The special rules are a deviation from the accepted definitions of income, accounting standards and the general norm of an income tax¹⁰⁰. Hence, the deduction of these employee related costs in South Africa is not something peculiar. As in the case of Kenya, the deductions are rightfully allowable and are not a form of incentive given to employers to invest in employees.

That said, let us consider the extent to which the employment tax incentive scheme in South Africa provides an incentive to employers in South Africa for development of human capital.

3.4.2.2 Employment Tax Incentive

South Africa operates an employment related tax incentive provided under the Employment Tax Incentive Act No. 26 of 2013. The structure of the employer incentive scheme is such that an employer remits a lesser amount of employment tax due on wages paid to qualifying employees¹⁰¹. This means that an employer offsets the stipulated incentive amount from the employment tax deducted on wages and remits the balance of the employment tax to the government. Based on the design of the scheme, an employer claims a higher amount towards the incentive in the first year of employing a qualifying person then the claim reduces in the second year of employment¹⁰². Moreover, the allowed claim under the employment tax incentive scheme should not exceed the wage specified under the Employment Tax Incentive Act¹⁰³.

The preamble to the Employment Tax Incentive Act states that the scheme is aimed at supporting employment growth, especially, in relation to young job

⁹⁹ See note. 13 p. 707 para 4.

¹⁰⁰ See note. 13 p. 707 para 4 et. seq.

¹⁰¹ Ebrahim A, Leibbrandt M and Ranchhod V, *The effects of the employment tax incentive on South African employment* (2017) *WIDER Working Paper*, p. 2 para 5.

¹⁰² See note. 101 p. 3 para 1 et. seq.

¹⁰³ Ibid.

seekers. The scheme is therefore narrowly focused towards encouraging employment of specific categories of job seekers. Thus, the scheme does not target to develop human capital in general. Notably, the fact that, through employing young work seekers there is some development of human capital is secondary to the goal of the scheme. As such, the incentive does not wholly meet the need for a direct employer tax incentive that encourages human capital accumulation.

Another point on the ETI is that it is very specific in design. This is because the amount of the incentive is highest in the first year and decreases subsequently. Thus, it rewards employers for absorbing job seekers into the market¹⁰⁴. The scheme does not, however, concern itself with what happens with the people after they are absorbed into the market. This is indeed a proper structure of the incentive for the intended goal of getting jobs for the specified job seekers. If the incentive aimed at developing human capital it would need to take a different structure which speaks to such a goal. For instance, since it is arguably in the second year and subsequent years that an employer starts to realize their investment, the incentive would be incremental rather than decrease if it aimed at generally developing human capital. This is presuming that the employee develops their skills with time hence the investment yields as it matures. Such a different design would mean that the employer realizes a significant benefit from the incentive if they keep their employee for longer than just the first year of employment¹⁰⁵. An incentive aimed at general development of human capital would therefore need to reward more than a onetime event of providing employment.

Overall, the ETI is an incentive aimed at a different purpose i.e. encouraging employment of certain categories of job seekers. If there is human capital accumulation, this is a secondary result from application of the scheme. Hence, a gap exists in South Africa on direct tax incentives available to encourage

¹⁰⁴ Section 7 of the Employment Tax Incentive Act.

¹⁰⁵ Judd KL, 'Taxes, uncertainty, and human capital' 1998 (88) *The American Economic Review* p. 290 para 3 et. seq.

human capital development by employers to achieve human capital accumulation.

3.5 Conclusion

The chapter has demarcated indirect tax incentives benefitting employers in Kenya and South Africa from the type of direct tax incentive proposed by this thesis. The chapter has also showed that based on the tax legislation in Kenya and South Africa, there exists insufficient direct tax incentives for employers that would contribute to human capital accumulation.

CHAPTER FOUR

4 THE RELEVANCE OF HUMAN CAPITAL AND JUSTIFICATION FOR A DIRECT TAX INCENTIVE FOR EMPLOYERS IN KENYA AND SOUTH AFRICA THAT CONTRIBUTES TO HUMAN CAPITAL ACCUMULATION

4.1 *Introduction*

Having shown that there exist insufficient direct tax incentives for employers in Kenya and South Africa that contributes to human capital accumulation, this chapter considers why such an incentive is necessary. In particular, the chapter considers the relevance of human capital accumulation and the rationale for giving a direct tax incentive to employers in both Kenya and South Africa.

To begin with, the chapter lays a background by looking at, first, the idea of human capital and its significance. Secondly, it looks at the relevance of human capital to both the global economy and the Kenyan and South African economies. Thirdly, it looks at how employers contribute to human capital accumulation. Lastly, it considers why a direct tax incentive given to employers would contribute to human capital accumulation.

4.2 *The Concept of human capital and its significance*

The human capital theory was conceptualized in 1776 by Adam Smith who noted that:

The annual labour of every nation is the fund which originally supplies it with all the necessaries and conveniences of life which it annually consumes, and

*which consist always either in the immediate produce of that labour, or in what is purchased with that produce from other nations*¹⁰⁶.

The human capital theory presents a change in thinking about labour for several reasons. First, it presents a different approach to labour by considering the fact that labour is a produced means of production and not only a factor of production¹⁰⁷. Besides that, the theory weights labour so that some types of labour are weightier than other kinds of labour¹⁰⁸. Hence, the theory does not treat labour as homogeneous. Lastly, the theory considers the economic impact made on individuals through social institutions like schooling and the family¹⁰⁹. The theory therefore presents a shift of view by economists on treatment of labour in economic analysis.

Economically, human capital is a significant factor in development of countries¹¹⁰. In the case of poor countries, for instance, it is noted that new physical capital is only put to good use when added gradually rather than through wholesale injection¹¹¹. This because poor countries digest the new capital at a slow rate since human capabilities do not stay abreast with physical capital supplied¹¹². As a result, these countries do not utilize the new physical capital acquired efficiently towards economic development. One may therefore say that this lack of or underdevelopment of human capabilities is a limiting factor in the economic growth of poor countries.

Human capital is also substantially responsible for the continued economic growth of the developed countries¹¹³. In the case of United States of America,

¹⁰⁶ Smith A, *An inquiry into the nature and causes of the wealth of nations* The Glasgow edition of the works and correspondence of Adam Smith ; 2. (Oxford, Clarendon 1976) p. 1 para 1.

¹⁰⁷ Bowles S and Gintis H, 'The Problem with Human Capital Theory--A Marxian Critique' 1975 (65) *The American Economic Review* p. 74 para 2.

¹⁰⁸ Ibid.

¹⁰⁹ Ibid.

¹¹⁰ Schultz TW, 'Investment in Human Capital' 1961 (51) *The American Economic Review* p. 1 para 1.

¹¹¹ See note.110 p. 7 para 2.

¹¹² Ibid.

¹¹³ See note.4 p. 2 para 1.

for instance, the contribution of human capital to economic growth doubled in the last century compared to the contribution of physical capital like land¹¹⁴. This was also the case for England where the industrialization process entailed an ongoing raise in human capital accumulation compared to the amount of physical capital¹¹⁵. Thus, the significance of human capital cannot be downplayed. But how relevant is it today?

4.3 *Relevance of human capital today*

This section first considers the relevance of the human capital theory to the world economy and then its relevance to the Kenyan and South Africa economies.

4.3.1 *Relevance of the human capital theory to the global economy today*

It was during the times of war where it was observed that:

*The failure to apply the concept of capital to a man was pernicious because one would sacrifice a hundred human beings in the prime of their lives without a thought in order to save one gun. The reasoning was that the purchase of a cannon caused an outlay of public funds, whereas humans could be had for nothing by means of a mere conscription decree*¹¹⁶.

Today, emerging economies view use of knowledge and intellectual intelligence as a means to win economic war against the developed and industrialized economies¹¹⁷. The use of wits as a weapon in the business world is commonplace and the means of survival in the globalized economy¹¹⁸. The

¹¹⁴ See note.4 p. 2 para 2.

¹¹⁵ See note.4 p. 2 para 3.

¹¹⁶ See note. 110 p. 2 – p. 3.

¹¹⁷ du Toit AS, 'Competitive intelligence in the knowledge economy: what is in it for South African manufacturing enterprises?' 2003 (23) *International journal of information management* p. 113 para 3.

¹¹⁸ Ibid.

global economy is therefore evolving with a key focus on developing the knowledge and creative economies¹¹⁹.

The next sections consider the relationships between the knowledge economy, the creative economies and human capital. The sections also look at the significance of the knowledge and creative economies in the world economy today.

4.3.1.1 *The knowledge and creative economies*

By way of definition, the knowledge economy refers to economic growth and wealth creation driven by intellectual know-how rather than by the traditional physical capital or natural resources¹²⁰. That does not mean that knowledge had no place in the past economic growth. Indeed, even before the advent of the knowledge economy, knowledge played a role in the production of wealth. For instance, a fisherman has always needed to know how to fish to grow a fishing business. In the knowledge economy, however, 'knowledge' is the key resource for wealth creation, productivity, and economic growth¹²¹. Put simply, under the knowledge economy mental exertion by people takes the place of physical exertion¹²². The knowledge economy uses knowledge-intensive activities to accelerate the production processes, to innovate and to stimulate most other business operations¹²³. The degree to which knowledge is put into economic and business activity is therefore much more substantial in the knowledge economy.

¹¹⁹ Brian K, *OECD Insights Human Capital How what you know shapes your life: How what you know shapes your life* OECD publishing 2007) p. 14 para 2.

¹²⁰ Powell WW and Snellman K, 'The Knowledge Economy' 2004 (30) p. 201 para 1 et. seq.

¹²¹ Muntean M-C, Nistor C and Manea LD, 'The knowledge economy' 2009 p. 141 para 1.

¹²² See note.121 p. 141 para 3 et. seq.

¹²³ Noel J and Qenani E, 'New age, new learners, new skills: what skills do agribusiness graduates need to succeed in the knowledge economy?' 2013 (16) *International Food Review* p. 18 para 1.

In addition to the focus on the knowledge economy there has also been a raise in focus on the creative economy¹²⁴. Whereas the creative economy is somewhat intertwined with the knowledge economy, for the creative economy growth accrues from ideas and creativity¹²⁵. The main driver of this type of economy is therefore the people with ideas who constitute the 'creative class. The creative class births ideas and creative content in different forms including, technology or any other innovative ways of doing things.

In the world today, both the knowledge and creative economies constitute the new economy which is the driving force behind wealth creation¹²⁶. This is seen in the effect that the knowledge and creative economies is having on businesses and countries. The next section highlights this.

4.3.1.2 Impact of the knowledge and creative economies on businesses and countries

Today, most businesses attach a high value to information and the sale of information¹²⁷. Further, the use of information to create new businesses is phenomenal and therefore businesses and entrepreneurs are keen on up scaling themselves in this respect¹²⁸. It is now imperative for businesses to shift their attention from physical resources to the more non-physical knowledge resource to deal with the current realities¹²⁹.

Moreover, the creation of knowledge and exploitation of knowledge currently plays a major role in generating wealth for countries¹³⁰. The exploitation of knowledge is critical to successful integration into the global economy¹³¹. The capability of a people to create, select, acclimatise, and use knowledge

¹²⁴ Veselá D and Klimová K, 'Knowledge-based Economy vs. Creative Economy' 2014 (141) *Procedia - Social and Behavioral Sciences* p. 415 para 1.

¹²⁵ Ibid.

¹²⁶ See note. 124 p. 417 para 2.

¹²⁷ See note. 119 p. 25 para 1.

¹²⁸ See note. 119 p. 25 para 2.

¹²⁹ See note. 121 p. 143 para 3.

¹³⁰ See note. 121 p. 141 para 1.

¹³¹ Warhurst C, 'The knowledge economy, skills and government labour market intervention' 2008 (29) *Policy Studies* p. 71 para 1.

economically is thus paramount to grow an economy and improve standards of living in a country¹³². This does not mean that a country must necessarily produce the knowledge to grow¹³³. It does however mean that a country must be capable of using, adapting, and applying the knowledge commercially to be able to grow¹³⁴. At the core of this need for the success of a country are human skills and capabilities. The upshot of this is considered in the discussion that follows below.

4.3.1.3 What is the effect of the knowledge and creative economies on human skills?

As noted, at the core of use of knowledge, adaptation and commercialization of knowledge is the stock of knowledge in a country i.e. the human capital accumulation¹³⁵. Thus, skills and creativity embodied in people make people the critical form of resource in this new economy. Notably, advanced economies have already moulded their policies in line with this reality of the knowledge economy¹³⁶.

Of great importance, however, is that the level, type and forms of skills required from people in the new economy is quite different¹³⁷. The required skills are mainly a competence that enables a person to perform tasks relevant to the knowledge and creative economy. There is therefore no concrete list of the specific skills required for the new economy¹³⁸. However, the general type of skills that seem to be popular in the new economy are largely generic skills and soft skills¹³⁹. Creativity is also in great demand due to the myriad of changes that a business needs to navigate in the new economy¹⁴⁰. The different learning institutions that develop and shape such skills include: homes, formal schooling

¹³² World Bank., *Constructing knowledge societies : new challenges for tertiary education* Directions in development (Washington, DC, World Bank 2002) p. 20 para 1.

¹³³ OECD, *The New Economy: Beyond the Hype* 2001) p. 9 para 3 et. seq.

¹³⁴ See note. 133 p. 22 para 1 et. seq.

¹³⁵ See note.121 p. 143 para 3.

¹³⁶ See note. 131 p. 71 para 1.

¹³⁷ See note.123 p. 16 para 1.

¹³⁸ See note.121 p. 150 para 3 et. seq.

¹³⁹ See note. 123 p. 19 para 2 et. seq.

¹⁴⁰ Ibid.

and the work place¹⁴¹. Of note, the work place, as a place to develop relevant skills has become quite important in view of the fact that businesses are now required to become learning organizations to keep the skills acquired by employees relevant and to develop lacking skills¹⁴². Additionally, firms find that they need to continually improve themselves to remain competitive in the new economy¹⁴³. This is especially due to the rapid change experienced in the way of doing things. Hence, once the relevant skills are developed there still needs to be continuous development of the skills to keep up with the demands resulting from the rapid changes.

The role that businesses play by continually developing their employees is thus indispensable to the knowledge economy. This dissertation argues that the government should also be an interested player in the process of development of human capital. This is especially because the level of knowledge stock within a country is significant for a country's economic growth¹⁴⁴. It is also worth mentioning that individual employees should equally have the obligation to ensure that they develop their skills to remain relevant within the economy. This impacting of skills by firms and obtaining of skills individually by employees contributes to human capital accumulation¹⁴⁵.

One may therefore conclude that due to the advent of the knowledge and the creative economy human capital accumulation is no longer a luxury but a necessity for the survival of businesses and whole economies. The question of need for human capital investment has therefore never been more important than it is in the current economy. That said, the next sections consider how human capital accumulation applies to Kenya and South Africa.

4.3.2 *Relevance of human capital to Kenya and South Africa*

¹⁴¹ Ananiadou K and Claro M, '21st century skills and competences for new millennium learners in OECD countries' 2009 p. 5 para 5.

¹⁴² See note. 131 p. 81 para 1.

¹⁴³ See note. 117 p. 113 para 2.

¹⁴⁴ See note. 133 p. 21 para 2 et. seq.

¹⁴⁵ See note. 5 p. 9 para 2.

In the modern world, developed economies are relying less on physical capital and more on innovation, creativity, and knowledge intensive activities for economic growth¹⁴⁶. As has been noted elsewhere, the key resource for this new economy is knowledge and hence human skills. The relevance of people with certain skills in the economy today is thus *prima facie* important. While this is the case, the specific peculiarities of Kenya and South Africa are considered below to determine the significance of human skills to their economies.

4.3.3 Kenya

Kenya has been experiencing progressive growth in its real Gross Domestic Product (GDP) with an estimated growth of 5.9% in 2017/18¹⁴⁷. The main sectors that contributed to growth in the GDP on the supply side were: the services sector, the agricultural sector and the industry sector¹⁴⁸. Of note, the services sector contributed to over half of the real growth experienced by Kenya in the year 2017/18¹⁴⁹. This has been a past trend where the services sector contributes to over half of the growth experienced¹⁵⁰. The wholesale and retail services sectors are the major sub-sectors that contribute to growth within the services sector¹⁵¹. The Information and Communications Technology (ICT) sector is also contributing significant growth following the digitalization of the government services which has reduced the cost of doing business¹⁵². The laying of the fibre optic cable through the country has also increased internet connectivity and access improving productivity¹⁵³.

Notably, within the African continent Kenya is above the curve in its ICT sector development¹⁵⁴. The benefit of ICT will however be realized with effective use

¹⁴⁶ See note. 133 p. 6 para 4.

¹⁴⁷ Group. ADB, 'African Economic Outlook 2019: Macroeconomic performance and prospects' 2019. p. 156 para 1.

¹⁴⁸ See note. 147 P. 156 para 2 et. seq.

¹⁴⁹ Ibid.

¹⁵⁰ Group. WB, 'Unbundling the Slack in Private Sector Investment – Transforming Agriculture Sector Productivity and Linkages to Poverty Reduction. World Bank, Nairobi.' 2019. *Kenya Economic Update, April 2019, No. 19* p. 4 para 4.

¹⁵¹ Ibid.

¹⁵² Ibid.

¹⁵³ See note. 150 p. 16 para 2.

¹⁵⁴ See note. 150 p. 25 para 3.

and commercialization of the technology¹⁵⁵. Kenya struggles with lack of the requisite skills to work within the technology sector¹⁵⁶. Therefore, it is essential that competencies are developed for the benefit of the existing technology to be realized. This is especially the case with the major technology developments that the government is embarking to complete by 2030 like the 'Konza Technology City' project¹⁵⁷ aimed at becoming 'Africa's Silicon Savannah'¹⁵⁸. In support of this project, the government has been allocating finances for investment in modern infrastructure¹⁵⁹.

As has been noted elsewhere, it is the proper use and manipulation of technology relevant businesses that provides social solutions¹⁶⁰. People skills are thus essential to adapt and assimilate technology to realize any benefit from the projects going on in Kenya. It therefore calls for Kenya to urgently start focusing on investments in people skills required to run the 'Konza Technopolis' project which is planned to take off by 2030. This is especially in view of the fact that skills within the ICT sector are significantly low¹⁶¹. Without a workforce which is able to exploit the technology Kenya will not achieve actual economic development from these projects.

Notably, in this 2019/20 budget there was a proposal to set up the 'Ajira Digital Program' whose aim is to bridge the gap between the current skills and skills required for operating in the digital economy¹⁶². Moreover, in the 2019/20 budget there was an allocation of funds to the digital literacy program to support the ICT sector in general¹⁶³. This might indicate that the government is cognizant of the need for development of human skills. That said, the

¹⁵⁵ See note. 133 p. 9 para 2.

¹⁵⁶ Sanchez Puerta MLdS, Sarah Johansson; Rizvi, Anam, 'Kenya : Capturing Skills Requirements and Assessing Skills Gaps in the Modern Economy' 2018 *Jobs working paper; no. 17, Washington, D.C. : World Bank Group*. P. 6 para 3.

¹⁵⁷ Ministry of Information CT, Kenya. , *Konza takes off with Kes.39 billion-infrastructure project commencement* (2018, September.) p. 1 para 1 et. seq.

¹⁵⁸ Tchamyou VS, 'The Role of Knowledge Economy in African Business' 2017 (8) *Journal of the Knowledge Economy* p. 1191 para 1.

¹⁵⁹ National Treasury RoK, *Budget Statement FY 19/20* (2019, June.) p. 22 para 4 et. seq.

¹⁶⁰ See note. 158 p. 1190 para 1 et. seq.

¹⁶¹ See note. 156 P. 6 para 3 et. seq.

¹⁶² See note. 159 p. 6 para 1 et. seq.

¹⁶³ Ibid.

government should urgently prioritize the development of human skills to increase the overall human capital accumulation in Kenya.

It is also essential for Kenya to develop the other elements of the knowledge economy for the country to compete in the global market¹⁶⁴. The main aspects to realize development in knowledge economy include, long run investment in education, building innovation capability and fostering a conducive market for commercial transactions¹⁶⁵. Once developed, there is also a demand for continuous adaptation of the skills since innovations arising continually require reinvention in the skills¹⁶⁶. Advancement in technology is therefore not the only area that the government of Kenya should be pursuing if Kenya is to realize growth in the knowledge economy.

Human capital accumulation should therefore be a key area of focus by Kenya. Hence, the Kenyan government ought to have a keen interest in developing human capital to realize a high human capital accumulation in the market.

4.3.4 *South Africa*

South Africa is one of the three largest economies in sub-Saharan Africa¹⁶⁷. In the year 2017/18 South Africa had an estimated real GDP growth of 0.7%¹⁶⁸. The sectors that contributed to the growth were agriculture, mining, and manufacturing¹⁶⁹. The services sector also contributed to growth with the financial sector being the main contributor¹⁷⁰. The growth of the services sector has however been regressing¹⁷¹. South Africa still relies on export of

¹⁶⁴ See note. 158 p. 1190 para 2 et. seq.

¹⁶⁵ See note. 158 p. 1191 para 2 et. seq.

¹⁶⁶ See note. 119 p. 30 para 1 et. seq.

¹⁶⁷ Bank. W, *Global Economic Prospects: Heightened Tensions, Subdued Investment* (2019, June) p. 122 para 1.

¹⁶⁸ See note. 147 P. 176 para 1.

¹⁶⁹ Ibid.

¹⁷⁰ Ibid.

¹⁷¹ See note. 147 P. 176 para 2 et. seq.

commodities, largely from agriculture and mining, as its main driver for economic growth¹⁷².

Notably, commodity export faces fluctuating global prices making it disadvantageous as the main means of wealth creation for a country¹⁷³. As an alternative to commodity export, there is a modern-day trend to rely more on use of knowledge and information to create wealth¹⁷⁴. Seeing as South Africa still relies on commodity exports for its economic growth, it might indicate that she has been adapting herself at a very slow rate to catch up with the global trends. This slow catch up to the global trends is one reason behind South Africa dropping in the global competitiveness ranking¹⁷⁵.

The 2019/20 government budget noted that due to the changing nature of the global economy there is need to be more skills-intensive and therefore there is need to change the country's development strategy¹⁷⁶. In the past, the South Africa development policy remained largely self-focused with the main emphasis being internal industrial development¹⁷⁷. As a result, the past development policies made little effort to integrate the South Africa economy into regional or global economies. The government is however attempting to prioritise skills development and to promote policies that foster skilled labour immigration into South Africa based on the government statement in the 2019/20 budget¹⁷⁸.

In the 2019/20 budget the government rightly notes that having a right public education system is at the core of bettering the country's economic potential¹⁷⁹. The government has thus proceeded to allocate a significant amount of money

¹⁷² Dessus SCH, Marek., 'outh Africa Economic Update : jobs and inequality (English).' 2018, April *South Africa Economic Update; no. 11. Washington, D.C. : World Bank Group.* P. vii para 2 et. seq.

¹⁷³ See note. 167 p. 121 para 1.

¹⁷⁴ See note. 133 p. 11 para 3.

¹⁷⁵ Africa NTRoS, *Budget Review, 2019* (2019, February 20) p. 13 para 1 et. seq.

¹⁷⁶ Ibid.

¹⁷⁷ See note. 147 P. 176 para 5 et. seq.

¹⁷⁸ See note. 175 p. 14 para 2 et. seq.

¹⁷⁹ See note. 175 p. 14 para 2.

in the 2019/20 budget towards the education sector¹⁸⁰. The funds are being spent on basic education and providing access to tertiary education.

The second approach that the government is taking is adopting policies that will encourage immigration of skilled labour into South Africa¹⁸¹. Arguably, this will meet the immediate demand for skills. Through immigration of skills there could be development of skills on the job. This is especially because knowledge is a non-rival product, meaning that it is transferrable by people learning from others.¹⁸²The immigration of skills should thus target at diffusing ideas, training and knowledge into the market. As part of the immigration strategy, South Africa should also target to bring entrepreneurs and innovators as innovations enhance strategic advantage for the economy¹⁸³. Of note, strategic advantage is important in the world where most businesses are depending on strategic use of intelligence to survive and to grow¹⁸⁴. For the immigration of skills to have effect, however, there is need not only for change of policies and laws but also change in the culture and for the society to adapt to the change¹⁸⁵. The government does indeed rightly recognize that to achieve economic development there is need for wide reaching structural reforms within the country¹⁸⁶.

While the immigration of skills is a quick remedy for the skills lacking in the market, this strategy will only serve to meet an immediate need in the market. In the long haul, however, human skills developed through formal schooling are essential for the growth of the knowledge economy in South Africa. The government is cognizant of this fact and hence is pursuing the enhancement of the public education system¹⁸⁷. Based on 2019/20 government budget speech it

¹⁸⁰ See note. 175 p. 2 Table 1.

¹⁸¹ See note 178 p. 14 para 2 et. seq.

¹⁸² Oketch MO, 'Determinants of human capital formation and economic growth of African countries' 2006 (25) *Economics of Education Review* p. 557 para 4.

¹⁸³ See note. 182 p. 557 para 2 et. seq.

¹⁸⁴ See note. 117 p. 113 para 2 et. seq.

¹⁸⁵ See note. 133 p. 19 para 4.

¹⁸⁶ See note. 175 p. 13 para 2.

¹⁸⁷ See note. 175 p. 14 para 2.

would appear that the South African government is cognizant of the need to increase human capital stock in South Africa to realize economic growth.

Having considered the need of human capital in both Kenya and South Africa, it is imperative to then consider what role employers can play in contributing to human capital accumulation. This provides the justification for giving employers an incentive. The next section considers this.

4.4 Ways that employers contribute to human capital accumulation

The processes of developing human capital consist of inter alia, formal schooling, training, professional development, and health interventions aimed at increasing knowledge, value, capabilities, and competencies¹⁸⁸. Formal schooling and training are the two-key process in human capital accumulation¹⁸⁹.

The some of the roles played by employers in regard to training are considered below. The discussion is however not exhaustive on all the roles that employers might play towards human capital accumulation. The section only looks at two main roles played by employers.

4.4.1 Initial equipping of graduates

The education system is at the core of human capital accumulation since it plays the main role in the initial moulding of potential employees¹⁹⁰. Usually, employers work with the products of the education system. Graduates from the education system ordinarily have no practical experience in the job market. Employers therefore take up a paramount role of equipping the products of the education system with the market skills that they lack from formal schooling. Through the opportunity provided, employees get the opportunity to hone the

¹⁸⁸ Marimuthu M, Arokiasamy L and Ismail M, 'Human capital development and its impact on firm performance: Evidence from developmental economics' 2009 (2) *Journal of international social research* ;Wang Y and Yao Y, *Sources of China's economic growth, 1952–99: incorporating human capital accumulation* The World Bank 1999) p. 266 para 2.

¹⁸⁹ See note. 188 p. 267 para 1.

¹⁹⁰ See note. 132 p. ix para 1.

skills acquired from the education system. Employers therefore bridge the gap between the skills acquired through formal schooling and the practical skills needed in the market. Thus, employers play a significant role in the initial equipping of graduates which contributes to human capital accumulation.

A second role played by employers is contributing to continuous development of skills as discussed in the next section.

4.4.2 *Continuous development of skills*

Aside from value addition made in equipping employees with lacking skills, there is now a burden for firms to continually develop their employee skills for the firms to succeed in the contemporary economy¹⁹¹. Lifelong learning is imperative within a business for it to achieve and maintain competitive advantage¹⁹². This is especially the case in the current knowledge and creative economy where firms need to anticipate market trends and make appropriate investments for the future¹⁹³. Inevitably, upgrading, and equipping employees with the skills required for the anticipated changes is a basic requirement to meet future needs¹⁹⁴. In this way, employers act as key contributors to human capital accumulation within an economy. Observably, firms have become basic units of the market economy and they are the main drivers of change in an economy¹⁹⁵. Work based training is therefore a major contributor to human capital accumulation.

Noting that employers play a role in human capital accumulation, it then follows to consider, why a direct tax incentive is the appropriate tool to spur employers

¹⁹¹ See note. 131 p. 73 para. 3.

¹⁹² See note. 117 p. 113 para 3.

¹⁹³ Debnath SC, 'Knowledge Economy Approach' 2010 (8) *International Journal of the Humanities* p. 216 para 1 et. seq.

¹⁹⁴ Powell WW and Snellman K, 'The Knowledge Economy' 2004 (30) p. 209 para 2 et. seq.

¹⁹⁵ See note. 193 p. 219 para 1.

towards more human capital development. The next section considers this aspect.

4.5 *Why a direct tax incentive?*

As noted earlier, governments use tax incentives to promote specific activities as part of development strategy¹⁹⁶. Further, taxes tend to influence businesses when making investment decisions¹⁹⁷. In this case, the dissertation proposes that the governments give a direct tax incentive to qualifying employees. A direct incentive is preferred for several reasons.

First, cost-based incentives are generally preferable to profit based incentives due to their various advantages¹⁹⁸. One advantage of cost-based incentives is that they reduce the cost of investment and they are likely to generate new investments that would otherwise not have been undertaken¹⁹⁹. Examples of cost-based incentives include, capital allowances and accelerated depreciation. As noted earlier, one concern for employers is the cost of investment in employees. Hence, a cost based direct incentive would presumably be best suited to achieve the purpose.

Secondly, the idea is that the proposed direct tax incentive mimics the type of tax incentive given for research and development. This is because this type of proposed incentive has some semblance with the research and development type of incentive. The semblance is in that a firm undertaking research imparts knowledge to the economy as would human capital development. Certainly, human skills development is peculiar due to the inability to keep human skills as a secret as in the case of research and development²⁰⁰. Nonetheless, like research and development, the economy gains by people acquiring the skill.

¹⁹⁶ See note. 7 p. 8 para. 2.

¹⁹⁷ See note. 7196 p. 11 para 2.

¹⁹⁸ See note 7 p. 20 para 3.

¹⁹⁹ See note 196 p. 20 para 3 et. seq.

²⁰⁰ See note. 182 p. 557 para 2 et. seq.

This is because even when employees leave their employers the skills are not lost but they circulate within the economy.

Lastly, a direct incentive would be preferable because it would target a qualifying group of people i.e. qualifying employers. This narrows the application of the incentive to a group that contributes to the goal of human capital accumulation. Such clarity of the eligible beneficiaries of the scheme contributes to efficiency in attaining the objective of the incentive²⁰¹. The direct nature of the incentive would also mean that it is focused and specific to this goal which shows the government's clear interest and its priority in encouraging human capital development. In the case of existing indirect tax incentives human capital accumulation is secondary to the other goals which indirect tax incentives are pursuing. An incentive specifically designed to achieve human capital accumulation has this as a primary goal thereby setting human capital accumulation as a priority.

4.6 Conclusion

This chapter has considered the concept of human capital and its significance. It then considered the relevance of human capital to the global economy and the Kenyan and South Africa economies. Next, it considered ways in which employers contribute to human capital accumulation. Lastly, it has looked at reasons why a direct tax incentive would be a good tool to achieve the goal of human capital accumulation.

²⁰¹ UN-DESA and CIAT, *Design and Assessment of Tax Incentives in Developing Countries* (2018) *United Nations*, See note. 11 p. 20 para 2 et. seq.

CHAPTER FIVE

5 SOME CONSIDERATIONS TO BE MADE IN ESTABLISHING AN IDEAL DIRECT TAX INCENTIVE THAT CONTRIBUTES TO HUMAN CAPITAL ACCUMULATION IN KENYA AND SOUTH AFRICA

5.1 *Introduction*

The last chapter proposed granting a direct tax incentive to employers in Kenya and South Africa. Under this chapter the thesis will propose some important aspects to consider in establishing the direct tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation. To this end, the chapter firstly proposes various factors to consider. Secondly, it considers the employers who should qualify for the direct tax incentive. Lastly, it considers the types of investments that should qualify for the incentive.

5.2 *Various factors to consider*

5.2.1 *The nature of human capital investments*

Ordinarily, human capital investments have an extra-dimension of risk compared to other investments²⁰². Furthermore, investment in human capital is unlike other forms of investments where investors can diversify their risks across various firms in their financial portfolios²⁰³. This is because the investment is always in people who are free agents. Thus, once an employer makes an investment the risk of an employee leaving before the employer recoups on the investment is always present.

The extent of the loss on investment by an employer depends on the type and level of investment in an employee. Arguably, in all cases an employer suffers loss of investment through the loss of an employee. This is because, at the bare

²⁰² See note. 105 p. 291 para 291.

²⁰³ Ibid.

minimum most employers invest in their employees by offering them on the job training. Whereas the on-job training is not an actual intentional training by employers, the employee perfects their skill through learning new skills and improving old skills²⁰⁴. Additionally, from an economic viewpoint there is value placed on the 'teaching' provided by other employees and the equipment and materials used to train²⁰⁵. Undoubtedly, these constitute costs since the employer could have used the resources spent in training to produce current output for the market. The employer however incurs the training time and costs anticipating increased future output by the employee or in anticipation of reduced production costs in future²⁰⁶.

Where on the other hand an employer offers some additional training over and above on the job training, the loss of investment is higher where an employee leaves. In this case, the additional training could either be general training or specific training²⁰⁷. In the case of general training the loss suffered is likely to be greater to an employer. This is because the general kind of training offered to an employee enables them to move to a competitor. The employer in such a case loses the opportunity to recoup the investment and impacts an advantage to their competitor²⁰⁸. In the grand scheme of things, however, though this would be a loss to the employer it is not bad for the economy because the stock of human capital remains within the market²⁰⁹. This highlights the unfortunate nature of this type of development because the developer cannot patent it. Hence, the developer of the skill is not protected against the potential of the skill transferring to a competitor²¹⁰. The initial cost of developing skills therefore ends up being high while the cost of reproducing it is very low²¹¹. As noted, this

²⁰⁴ Becker GS, *Human capital : a theoretical and empirical analysis, with special reference to education* (New York, National Bureau of Economic Research 1964) p. 11 para 1.

²⁰⁵ See note. 204 p. 11 para 2 et. seq.

²⁰⁶ See note. 204 p. 11 para 4 et. seq.

²⁰⁷ See note. 204 p. 12 para 4.

²⁰⁸ Ibid.

²⁰⁹ See note. 182 p. 557 para 4 et. seq.

²¹⁰ Ibid.

²¹¹ See note. 182 p. 557 para 1 et. seq.

phenomenon is likely to occur in the general training which is also the most likely form of training offered to inexperienced employees.

Specific training is however a bit different because the employer imparts skills that increase productivity within the firm offering it²¹². An example of specific training is imparting a skill on use of a particular technology that is specific to the business. Another example would be training a person on some unique way of doing things that is not necessarily in use by other similar businesses. An employer who loses an employee in such a case would also suffer loss since they lose specialized skills instilled in the employee²¹³. The cost of training another employee to be able to master the specific skill would be an additional cost to an employer²¹⁴. The loss in this case is therefore very specific to the employer. Nonetheless, even in the case where skills are specific, the skills remain in the market when the employee leaves the employer which would count towards the stock of knowledge in the economy. In any case, the presence of skills in the economy has been noted to contribute to growth ultimately even if it is indirectly through people being civically responsible²¹⁵.

Overall, risk is inherent in human capital investments hence employers need some form of protection of their investment²¹⁶. Lack of such protection would mean that the employer incurs a cost that has economic value without any guarantee of recouping the investment. The design of the incentive should therefore seek to eliminate or reduce the risk inherent in the nature of human capital investments.

5.2.2 *Peculiarities of human capital*

In its nature human capital is peculiar for a number of reasons. First, as noted earlier, it is a type of capital that develops concurrent with use hence is not

²¹² See note. 204 p. 17 para 3 et. seq.

²¹³ Ibid.

²¹⁴ See note. 204 p. 18 para 1 et. seq.

²¹⁵ See note. 182 p. 558 para 5.

²¹⁶ See note. 23 p. 2 para 3.

merely a supply of labour. Secondly, human capital investments may appear as consumption but a keen evaluation of the expenses will show that they are investments not merely a consumption. The design of the incentive should take these peculiarities into account. An illustration of how the design could take these peculiarities into account is the approach taken in the case of tax treatment of pension contributions. For tax purposes, pension-fund contributions are deducted at working-year therefore they reduce the taxable income while pension distributions are taxed during retirement years when the tax rate is likely to be lower²¹⁷. The effect of this is that the employee realizes a real benefit since they get a deduction on the tax base at the point of making the pension contribution and at the same time get lower tax rate at point of taxation.²¹⁸.

Some ways to cater for the peculiar blend of factors in human capital include, first, expenses incurred by employers for development of employees could be treated as a form of investment not merely as an expense or consumption. Secondly, foregone revenue arising from time spent in training inexperienced staff or improving the skills of experienced staff could constitute a form capital investment. If this approach is taken, an incentive like incentives given for capital expenditure like a depreciation allowance could then be accorded to these investments.

5.2.3 *Consider what would be a real incentive for employers*

Just like any form of investment the incentive to invest in employees depends on the rate of return expected²¹⁹. Arguably, the core aim of profit-making businesses is to make profit not to train or invest in employees. Hence, employers' in such cases value experience as this contributes immediately to productivity and therefore will prefer to hire experienced employees and forgo an insignificant incentive given to train inexperienced hires²²⁰. This is especially

²¹⁷ See note. 42 p. 1499 para 4.

²¹⁸ See note. 42 p. 290 para 4 et. seq.

²¹⁹ See note. 204 p. 18 para 4 et. seq.

²²⁰ Ranchhod V and Finn A, *Estimating the effects of South Africa's youth employment tax incentive—an update* 2015) p. 200 para 3 et. seq.

the case where the profit foregone in employing inexperienced staff is not comparable to the incentive provided for hiring inexperienced employees. The incentive should therefore aim to encourage firms to undertake such training.

Kenya and South Africa could borrow examples of real tax incentives within the human capital sphere from other countries. By way of example, in Australia the whole cost of training expenses is deductible against the taxable income plus an additional 20% of the training expense²²¹. In effect therefore, a 120% tax deduction is granted on training expenses. Furthermore, in the case where firms are in tax loss and therefore cannot make enough profit to benefit from this tax allowance, they can claim a tax credit of 6% of the actual training expenses²²². Such a design is likely to have a felt impact by employers which could encourage the investment.

5.2.4 Consider a taking targeted approach

Following from the previous discussion on the need to provide a real incentive, taking a targeted approach in designing the incentive could help in this regard. The targeted approach will, essentially, mean developing a customized incentive for a specific target. Of note, a customized incentive might mean having a multifaceted incentive or multiple incentives. The targeted approach could take several angles including:

5.2.4.1 Incentive developed along the structure of businesses

Under this, the incentive may be designed according to the size of a firm, the number of employees and the employee composition. The incentive could then provide a different rate of tax or deduction for small sized businesses and large businesses. In determining the amount of incentive in this case the capacity of smaller businesses vis- a – vis bigger businesses to invest would be factored into the design. Moreover, the effect of loss of trained employees might be felt

²²¹ See note. 23 p. 9 para 2.

²²² See note. 23 p. 9 para 3.

differently by the smaller businesses and bigger businesses. This is because a small business would potentially bear a greater burden in training additional staff after losing existing staff. The design should therefore take this into account.

Employee composition in a business i.e. whether employees in a business are experienced or inexperienced could also be an important factor to consider in the design. Different amounts of incentives could, therefore, apply depending on the composition of employees in the firm and which employees receive investment. As noted earlier, employers tend to invest more into employees who are in senior levels. To encourage even distribution of human capital investments different rates of incentives could be provided.

5.2.4.2 Incentive developed depending on skills required in the economy

Ultimately, the country specific needs should determine the skills to encourage through the incentive. For example, if a country needs informal skills then the incentive should be couched towards encouraging development of such skills. In the case of Kenya and South Africa, for instance, each country needs different kind of skills. The structure of the tax incentive should lean towards encouraging development of the skills that each country needs.

5.2.4.3 Develop an incentive based on the type of investment

Under this, the structure of the incentive could be based on the type of investments that an employer makes into their employees. In this case, the policy makers would identify the activities that they would like to encourage and provide an incentive for investing in such activities. Of note, this is the structure adopted by both Kenya and South Africa in the design of the incentives aimed at encouraging employment of young people.

Later in the chapter some activities that would constitute investments are proposed. By way of mention however, this approach could be used to encourage activities like maintaining human capital through investments into mental wellness. Further, such an approach could be adopted to encourage companies to make technical changes through providing incentives in training when a company is in the process of implementing technical changes.

Another factor that needs to consider in establishing the direct incentive is which employers should qualify for the incentive. The next section considers this.

5.3 Consider which employers should qualify for the incentive

The dissertation makes some three arguments on the categories of employers who could be considered as contributing to human capital accumulation. The following discussion makes the three arguments.

5.3.1 Case for all employers

The first argument is that knowledge obtained from work-based training is a kind of tacit knowledge gained from having contact with machinery used at work, exposure to work culture and influence by peers²²³. This kind of tacit knowledge is compared to the skill used to ride a bicycle or to swim. The skills are experiential kinds of skills rather than skills developed from reading a book²²⁴. Thus, in the market, tacit skills would be what employers' term as 'experience' which has a premium attached to it²²⁵. Such experience is a relevant form of skill valued within a competitive environment since a firm suffers a real loss where an experienced employee leaves for a competitor²²⁶.

²²³ Howells J, 'Tacit knowledge' 1996 (8) *Technology analysis strategic management* p. 93 para 1.

²²⁴ See note. 223 p. 93 para 3.

²²⁵ See note. 223 p. 95 para 2 et. seq.

²²⁶ Ibid.

Thus, this knowledge though not codified in the form of a college certificate is a form of investment by employers.

Based on this argument, this type of investment may be in any sector i.e. in the service sector or the commodities sector since the only requirement is for employees to be exposed to the workplace. This being the case, employers in any sector contribute to human capital accumulation. Hence, all employers in any sector should qualify to enjoy the employer incentive.

5.3.2 *Case for employers in a competitive environment as relevant contributors*

This is the second argument and it considers work-based training provided by firms within a competitive market to be the most relevant. This is because competitors tend to shape expectations for the future and force their counterparts to keep reinvesting in themselves²²⁷. Arguably, the work-based training within a competitive environment since is innovative, rapid and significant due to pressure from the competition. Moreover, competition is likely to force a firm to innovate and differentiate itself in the market. This wholesome process of developing a firm to become the expert in a field to compete effectively necessitates development of human skills²²⁸. Like under the first argument, the learning and skills obtained from such an environment would be a form of tacit knowledge that can neither be communicated in a classroom nor codified²²⁹. The steps taken to create expertise by a firm in a competitive environment may be likened to a music performer developing themselves to become an expert²³⁰. This means that the skills instilled into employees in the process of developing the competitive edge are relevant, diverse but not necessarily explainable.

²²⁷ See note. 193 p. 231 para 3 et. seq.

²²⁸ Eikeland O, 'Symbiotic Learning Systems: Reorganizing and Integrating Learning Efforts and Responsibilities Between Higher Educational Institutions (HEIs) and Work Places' 2013 (4) *Journal of the Knowledge Economy* p. 106 para 3.

²²⁹ See note. 223 p. 93 para 3.

²³⁰ See note. 228 p. 106 para 4 et. seq.

Put simply, the argument says that employers working within a competitive environment as opposed to a non-competitive environment are more apt to develop human capital. Thus, based on this argument businesses operating within a competitive market contribute more significantly to relevant human capital accumulation than businesses in a non-competitive environment. Hence, the argument would suggest that only employers within a competitive environment should qualify to enjoy the benefits of the proposed direct tax incentive.

5.3.3 *Case of employers offering training towards accreditation*

Lastly, employers who offer work-based training and learning that is organised and structured have a more direct impact on human capital accumulation²³¹. The training by such employers constitutes practices like the continuous professional development courses offered by different professional bodies like the Law Societies and Engineering institutes.

Moreover, this category of employers includes those employers who offer some form of training that counts towards giving formal education accreditation. This could be the case for internships offered to students who are required to undertake an internship as part of their curriculum. Arguably, it is the exposure of the interns to the practical work environment that is the aim in requiring practical training as part of the curriculum. Hence, these employers may be included in the first argument.

While the three arguments are thus resented, it is notable all employers, whether in a competitive market or not, whether providing training for actual accreditation or not contribute to human capital development. This is especially because exposure of employees to the workplace in all cases contributes to equipping them. However, if the government were to consider the arguments

²³¹ Sobiechowska P and Maisch M, 'Work-based learning: in search of an effective model' 2006 (14) *Educational Action Research* p. 267 para 1.

narrowly, employers within a competitive environment would be more apt to contribute to human capital development. If taken very narrowly, the government may consider that it is employers who are involved in accredited training that contribute to quantifiable human capital accumulation.

Overall, this dissertation argues that every employer plays a different but important role in human capital accumulation. This being the case, the dissertation proposes that all employers in all sectors should enjoy the tax incentive aimed at human capital accumulation. This is irrespective of sector or whether they are in a competitive environment or a non-competitive environment. Nonetheless, the design of the incentive should consider all the other factors proposed for consideration. The needs of Kenya and South Africa should also determine which employers may be preferable for the incentive.

The chapter lastly proposes that the design of the incentive considers the types of activities undertaken by employers that should constitute an investment in human capital. The next section considers this.

5.4 Consider what types of activities constitute an investment

This part proposes three main forms of investments that the government could treat as an investment by employers.

5.4.1 Any range of activities that have a discern-able return

A wide range of activities may fall within the realm of human capital investment including, schooling, on-the-job training, and medical care²³². That said, the investment angle on some expenses is not straightforward. Hence, there is always the question as to whether these costs constitute a pure investment or consumption. For instance, the line is blurred on, when health expenditure would amount to an investment and when it would be consumption. It might

²³² See note. 5 p. 9 para 2.

thus help to consider what would be the distinguishing factor between investments and consumption.

Primarily, the distinction between investments and consumption is that investment activities tend to affect future well-being and future earnings while consumption activities have their main impact in the present²³³. That noted, the distinction may still not be very clear since some activities may affect both future earnings and consumption. An example would be college education. Arguably, such dual activities constitute both an investment and consumption²³⁴.

To justify an investment there should be some economic return²³⁵. The return may accrue to the individual, the employer, or the economy as a whole. Individuals get a return through increased wages or salary. On the other hand, employers get a return from reduction in production costs or increased profits. The economy at large realizes a return from an increase in the output of goods, an increase in the output of services and observable economic growth²³⁶.

Based on these considerations, the governments of Kenya and South Africa could consider all the costs that meet the investment criteria i.e. yield a return as an investment for the purposes developing an appropriate tax incentive. The government in each of the countries should however determine which activities would meet the needs of the economy and lean towards these types of activities.

5.4.2 *Investments in the knowledge economy and towards development agenda*

While general investments should benefit from the incentive, the governments of Kenya and South Africa should take a keen interest in encouraging investments appropriate to grow the knowledge economy. As noted elsewhere,

²³³ See note. 5 p. 9 para 1 et. seq.

²³⁴ Ibid.

²³⁵ See note. 204 p. 9 para 2 et. seq.

²³⁶ See note. 6 p. 1 para 1.

the knowledge economy is the new economic environment where knowledge drives productivity²³⁷. Also as noted earlier, the knowledge economy is currently the main driver of the world economy. Hence, the governments of Kenya and South Africa should intentionally develop investments within this sector. For investments to fall into this category they should produce knowledge workers and increase the productive use knowledge since these are the factors that propel growth in this type of economy²³⁸.

It would also be important to state that the knowledge economy is in its nature multidimensional and requires collective input by employers, individual employees and the government²³⁹. Therefore, the government on its part can contribute significantly to the knowledge economy by supporting on job training infrastructure²⁴⁰. To this end, the government could use on job training strategically to grow the knowledge economy. Through the proposed incentive, the government can strategically push employers towards investing in developing knowledge driven type of skills. These could be skills that encourage creativity, innovations and freelance thinking.

Furthermore, the governments of Kenya and South Africa should seek to fill out the existing skills gaps in their countries to fulfil their development agendas. Looking at the development agenda of Kenya for instance, the government is currently building on technology advancement with the ongoing construction of ‘Konza Technopolis’. This being the case, there is an immediate need to equip people with skills needed to work in the technology front. The government in the 2019/20 budget allocated funds to the ‘Ajira Digital Program’²⁴¹ which is aimed at bridging the skill gap between the available skills and the market demand in the digital sector²⁴². Arguably, this is an example of strategic

²³⁷ Maric I, Barisic P and Jurjevic I, *Knowledge and skills needed in knowledge economy* (2012) Varazdin, Faculty of Organization and Informatics Varazdin, p. 184 para 5 et. seq.

²³⁸ Ibid.

²³⁹ See note. 193 p. 230 para 3.

²⁴⁰ See note. 193 p. 224 para 3 et. seq.

²⁴¹ See note. 159 p. 6 para 1.

²⁴² Ibid

development of needed skills. The government should be equally strategic in moving businesses and individuals to other economic development dimensions. For the knowledge economy much more is needed in addition to advancement in technology. As noted, the knowledge economy is more than use or advancement in technology of itself²⁴³. The knowledge economy also has to do with commercialization of technology resulting in growth of e-commerce and innovation²⁴⁴. The government of Kenya should therefore encourage all rounded growth in skills in addition to advancement in technology.

As regards the development agenda in South Africa, there is support for businesses registering patents in other countries to protect discoveries made in South Africa ²⁴⁵. Further, in the 2019/20 government budget the government allocated a significant amount of funds to the education sector with the aim of developing skills needed in the economy²⁴⁶. On the technology side, South Africa is marked as a major importer of technology²⁴⁷. This might signify need for technology skills in South Africa to make productive use of the imported technology. Importing the technology rather than producing the technology is in itself is not a bar to growth since a country need not produce technology to be strong in the knowledge economy²⁴⁸. A country however needs to make optimal use of the technology once acquired to produce any commercial benefits. The South African government should be strategic in encouraging development of human skill to meet such demands its market²⁴⁹.

Once pains have been borne to develop the skills, it is paramount that the human capital created remains at its optimum. This is largely a responsibility on the users of human capital who are, largely, employers. Hence, activities involving

²⁴³ See note. 133 p. 21 para 2.

²⁴⁴ Ibid.

²⁴⁵ Blankley WO and Booyens I, 'Building a knowledge economy in South Africa' 2010 (106) *South African Journal of Science* p. 3 para 3.

²⁴⁶ Africa NTRoS, *Budget Review, 2019* (2019, February 20) p. 2 Table 1.

²⁴⁷ See note. 245 p. 3 para 7 et. seq.

²⁴⁸ See note. 133 p. 9 para 2.

²⁴⁹ See note. 172 P. vii para 4 et. seq.

maintaining of human capital could constitute a form of investment. The next section considers these activities.

5.4.3 *Investments to maintain human capital*

To begin with it is important to note that physical capital depreciates, and it is an accepted practice that a depreciation allowance is granted on such capital²⁵⁰. Furthermore, various steps are taken to maintain physical capital through routine repairs and maintenance. Turning to human capital, there has been a question on whether such capital depreciates in a similar way as physical capital²⁵¹. Arguably, human capital depreciates since skills are lost through disuse or obsolesce. Loss of skills through obsolesce could arise due to change in technology where existing skills do not matching up to the technology. In such a case however, the skills could be used again by upgrading the skill to match up with the technology. There could also be a loss of skills through disuse resulting from unemployment or interruptions from work²⁵². The skills in such a case are also not entirely lost but eroded so that they may be reconstructed and get back into optimal use²⁵³. If these were the only factors that affect human capital one may conclude that the depreciation of human capital is not worrisome since the skills can be repaired. The underlying driver of depreciation of human capital is however not merely disuse of obsolesce but health²⁵⁴. Of note, health in this case includes both physical and mental health.

While disuse and obsolesce leave room for rectification, a failure of health could result in a total annihilation of the stock of human capital. Since the capital is embodied in people, a healthy person is required to acquire and use skills

²⁵⁰ McFadden D, 'Human Capital Accumulation and Depreciation*' 2008 (30) *Applied Economic Perspectives and Policy* p. 380 para 1 et. seq.

²⁵¹ Ibid.

²⁵² Mincer J and Ofek H, 'Interrupted work careers: Depreciation and restoration of human capital' 1982 *Journal of human resources* p. 3 para 1.

²⁵³ See note. 252 p. 4 para 2 et. seq.

²⁵⁴ Mushkin SJ, 'Health as an Investment' 1962 (70) *Journal of Political Economy* p. 135 para 5 et. seq.

optimally²⁵⁵. Health is therefore that pivotal point of interaction between human capital accumulation and depreciation²⁵⁶. This is because a healthy person with stamina will acquire skills and is able to use them while the failure of health in the same person could take away both the ability to acquire skills and the capability of using the skill. Arguably, health in its various forms is a cornerstone to human capital accumulation and performance.

Of note, some economists view health, of itself, as a form of human capital investment due to the importance of health in human capital²⁵⁷. Understandably so, because in the absence of healthy human beings there would be no discussion on human capital. Nonetheless, looked at from any angle, health constitutes the very essence of the 'machine' in the case of human capital. While health in its entirety i.e. physical and mental health is important, a point to recall is that production in the current knowledge and creative economies relies extensively on mental exertion. Consequently, mental health should be accorded special interest in the modern economy. This is especially since brain power is now being exploited by businesses to perform for the businesses. A healthy mind in this current economy is therefore an asset for a business and the means for an individual to earn a living²⁵⁸. Suffice to say, mental illness may not be caused by the work but may be brought to the workplace. Nonetheless, the mental illness will impact the productivity at work by such an individual with the additional pressure from exertion of the mind at work²⁵⁹.

In the recent years, it is an increasing trend that mental illnesses are the top causes of loss of labour, unemployment, absence from work and low productivity²⁶⁰. Other factors bear witness to the mental health phenomena like the increased cost of mental health to public health systems²⁶¹. Additionally,

²⁵⁵ See note. 254 p. 131 para 4.

²⁵⁶ See note. 250 p. 381 para 1 et. seq.

²⁵⁷ See note. 254 p. 130 para 6.

²⁵⁸ Deloitte UK, 'Mental Health and Employers: A case for investment ' 2017, October. *Deloitte Monitor*. P. 1 para 2 et. seq.

²⁵⁹ OECD, *Sick on the Job?* 2012) p. 88 para 1 et. seq.

²⁶⁰ See note. 259 p. 11 para 1 et. seq.

²⁶¹ See note.259 p. 11 para 2 et. seq.

there is a current trend of increase in the number of workdays lost due to mental health²⁶². Further, there is an observed rate of reduced productivity from individuals who would be present at work while mentally ill²⁶³. The mental health angle is therefore key to maintaining a healthy capital investment. Whereas that is the case, the issue of mental health is largely neglected, and little attention is paid to it²⁶⁴. This neglect has been linked to lack of awareness on what constitutes mental illnesses and as a result people do not seek redress²⁶⁵. Additionally, those who face mental illness are unwilling to disclose this fact or to seek assistance²⁶⁶. The lack of employer support and lack of support for the common mental illnesses also impacts on the willingness by employees to seek help²⁶⁷.

Be that as it may, some measures that would curtail the prevalence of the mental illnesses could be taken by the employers to maintain their investment in people²⁶⁸. Measures like, providing better working conditions, deliberate change of the work culture to make it conducive for mental health, creating awareness of mental illnesses and providing support for those with common mental illnesses have been identified as helping to combat the phenomena²⁶⁹. These costs incurred towards supporting and providing assistance on mental illnesses would help to maintain human capital. Hence, the costs should constitute a form of investment.

The structure of a tax incentive to encourage human capital investment should therefore also aim at capturing this aspect of maintenance of human capital. Without proper maintenance of the investment, a cycle of developing the capital and running it down to waste will result. This will not achieve the ultimate goal

²⁶² See note. 258 P. 1 para 6.

²⁶³ See note. 258 P. 1 para 7.

²⁶⁴ See note. 259 p. 11 para 1 et. seq.

²⁶⁵ See note. 259 p. 14 para 2.

²⁶⁶ Ibid.

²⁶⁷ See note. 259p. 14 para 6.

²⁶⁸ See note.258 P. 2 para 1.

²⁶⁹ OECD, *Fit Mind, Fit Job* 2015) p. 13 para 2.

of obtaining human capital accumulation within the Kenya and South Africa economies.

5.5 Conclusion

The chapter has dealt with three main aspects. To begin with, the chapter proposed various factors to consider in establishing a direct incentive that contributes to human capital accumulation. Secondly, there was some discussion on what to consider as regards which employers would qualify for the direct tax incentive. Lastly, the chapter looked at some types of investments that could constitute forms of investment into human capital development.

CHAPTER SIX

6 PROPOSED REFORMS AND RECOMMENDATIONS

6.1 Introduction

This chapter makes recommendations and proposals on what an ideal tax incentive for employers that contributes to human capital accumulation should look like for Kenya and South Africa.

The approach taken is to evaluate the current tax rebate scheme offered to encourage employment of graduates in Kenya and the similar Employment Tax Incentive (ETI) Scheme offered in South Africa. The evaluation entails measuring the existing direct tax incentives against the framework of the general characteristics of any ideal tax incentive discussed under chapter 3. Following the evaluation, the dissertation then suggests reforms or modifications to be made when establishing a 'like' direct tax incentive that contributes to human capital accumulation.

Of note, the tax rebate scheme offered to encourage employment of graduates in Kenya and ETI Scheme offered in South Africa are a type of the direct tax incentive proposed by this thesis because they benefit employers directly. Kenya and South Africa should ensure that the deficiencies identified in these existing direct tax incentives schemes are not reflected in the structure of the proposed direct employer incentive. That said, the considerations highlighted in the last chapter should also be borne in establishing this ideal direct tax incentive.

It is important to state, however, that the proposal is not that there should be a reform of these existing incentives i.e. the tax rebate scheme offered in Kenya and ETI Scheme offered in South Africa. Rather, the proposals are on reforms that should be borne in made when designing a like incentive scheme. The next section considers these proposed areas for reform by each country.

6.2 Kenya

6.2.1 Transparency

The rebate system, *prima facie*, meets the transparency criteria since it is prescribed under the KITA²⁷⁰ and its implementation is stipulated under Regulations²⁷¹. Based on the Regulations it is clear that the target group for the rebate is employers who employ at least 10 university graduates and whose income is not wholly exempt from tax²⁷². Additionally, the Regulations require an employer to register the apprenticeship agreements with the National Industrial Training Authority and for the engagement to be for a period of 6 to 12 months.

As regards the administration of the rebate system, an employer wishing to use the rebate system faces several administrative hurdles. In the first place, an employer should not engage a graduate apprentice without the written consent of the Director General of the National Industrial Training Authority²⁷³. Secondly, the apprenticeship contract is only binding for purposes of the rebate if it is registered with the Director General of the National Industrial Training Authority²⁷⁴. Then, on completion of the apprenticeship the employer is required to submit a certificate of completion in the prescribed form to the Director General of the National Industrial Training Authority²⁷⁵. The employer should then maintain certified copies of the apprenticeship contract and the

²⁷⁰ Section 39B of the Kenya Income Tax Act.

²⁷¹ The Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016.

²⁷² The Paragraph 3 of the Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016 defines an eligible employer as an employer who is subject to tax under section 3 of the KITA other than an employer whose income is wholly exempt.

²⁷³ Paragraph 4 of the Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016.

²⁷⁴ Paragraph 5(2) of the Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016.

²⁷⁵ Paragraph 6 of the Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016.

apprenticeship certificate for every apprentice certified by the Director General of the National Industrial Training Authority²⁷⁶.

While the various hurdles are set to act as safeguards against abuse, the safeguards could nonetheless become a hindrance to the use of the rebate. For instance, the requirement for employers to first seek consent to engage apprentices is onerous and unnecessary. Moreover, it is not clear what the Director General is required to evaluate to give the written consent. Hence, giving of the consent seems to be at the discretion of the Director General. Such discretionary power in relation to a tax incentive may lead to corruption making the incentive ineffective.

For more transparency, where a person meets the qualifying criteria the incentive should be automatically triggered²⁷⁷. For instance, once an employer engages the minimum number of graduates, they should automatically apply the rebate. This is provided that they can demonstrate, if required, that they met this qualifying criterion. This is an area for possible reform. Moreover, as far as possible, there should be minimal involvement of government officials who exercise discretion on the incentive. This is because such involvement may compromise the transparency of an incentive.

6.2.2 *Practical effectiveness*

This aspect encompasses various considerations. In the first instance, the rebate system should be working effectively to provide an incentive for employers to engage graduates. At the point of writing this dissertation there is no study was found that determines whether employers are intentionally employing graduates who they would otherwise not engage because of the incentive offered by the rebate program. Moreover, no study has been found showing if employers find it rewarding to engage graduates because of the rebate.

²⁷⁶ Paragraph 7 of the Income Tax (Set-off tax rebate for graduate apprenticeships) Regulations 2016.

²⁷⁷ See note. 42 p. 1502 para 1.

As noted earlier, however, the incentive provided by the rebate is, arguably, comparatively less than the training and input made into the graduates by the employers. Additionally, the rebate would not immediately benefit employers in tax losses. However, since the law allows for tax losses to be carried forward for nine years from the year incurred²⁷⁸, employers would eventually benefit from the reduction. Whereas this is the case, firms in losses may not be very responsive to the rebate as they might respond to a tax credit²⁷⁹. This is because for employers in a tax loss the benefit is deferred until the point that the business is in a tax paying position. Thus, the structure of the rebate in the form of an additional deduction of an expense might be working to reduce the effectiveness of the tax rebate system. The proposed incentive should take this into account as a possible area for reform.

The other aspect of practical effectiveness is to consider whether non-tax related economic factors at work in the economy might make the incentive ineffective. Other non-tax related factors include political factors, inflation, structural deficiencies among others²⁸⁰. These factors would cause businesses to perform poorly so that they cannot afford to employ graduates despite the rebate. In essence, where the economy is not performing well then, the tax rebate cannot achieve increase in employment of graduates because the economy cannot absorb them. An analysis of the economic state of Kenya is beyond the scope of this dissertation. Nonetheless, it would be important to note that other reforms such as addressing issues like corruption may be necessary to make the proposed incentive effective.

6.2.3 *Design and evaluation*

²⁷⁸ Section 15(4) Kenya Income Tax Act. An application for extension of the period that the loss might be carried forward may be made if the loss has not been utilized within the prescribed period of nine years.

²⁷⁹ Cummins JG, Hassett KA and Hubbard RG, 'Have Tax Reforms Affected Investment?' 1995 (9) *Tax Policy and the Economy* p. 133 para 2.

²⁸⁰ See note. 42 p. 1499 para 4.

This aspect of the tax rebate system is possibly the one where the rebate system is least compliant. The rebate system is a general one size fits all type of incentive and partly misses out on its objective. For instance, employers whose income is tax exempt cannot use the incentive. In any case, if such employers could use the incentive, it would not have an impact on them because their income is not taxable. This design therefore loses sight of the fact that such tax-exempt firms are also employers. If the rebate system were more efficient, such employers could possibly be allowed to get a cash refund for engaging the apprentices. In the alternative, the employers in such a case could be allowed to retain a portion of employment tax deducted from the employees' wages as is the case in the ETI Scheme offered by South Africa. The proposed incentive should not follow this one size fits all approach.

Moreover, the design of the incentive does not seem to take into consideration what employers would be looking for in a tax incentive. For instance, mitigation of the risk of investing in graduates does not seem to play any role in the design of the incentive. The nominal amount of tax rebate given compared to the amount of training that would be provided to the graduates would testify to this. Arguably, this aspect is irrelevant since the goal of the scheme is only to encourage employment. Nonetheless, the rebate system should aim to give a real incentive so as to appeal to employers. The proposed incentive should aim, as far as possible, to give a real benefit to employers. Furthermore, there is no clear evaluation criteria for the government to determine if the rebate is achieving any objective. The proposed incentive should have a clear evaluation mechanism.

6.2.4 Cost effectiveness

On this, the consideration is whether the gains from the rebate outweigh the cost of the rebate. The direct cost in this case is the revenue foregone by the government. Again, no study has been found determining the extent of the benefit that is flowing from the rebate. Nonetheless, the design of the rebate

highlighted above potentially reduces the benefits of the rebate system significantly. The design of the rebate system is very important to reap the desired objective, otherwise, the foregone revenue might be merely a free monetary gift given by the government²⁸¹. This is because it is likely that only employers who would, in any case, have engaged graduates engage them. This is with an exception of small businesses who might find the rebate significant to their costs. The proposed incentive should therefore meet its specific objective to be cost effective. The incentive should, as far as possible, aim to attract those employers who would not have invested into human capital. This is as opposed to simply being used by employers who would have invested in their employees without the incentive.

6.3 *South Africa*

6.3.1 *Transparency*

The law embodies the provisions on the Employment Tax Incentive (ETI)²⁸². The law specifically defines employers who would be eligible for the incentive²⁸³. Further, section 2(2) of the Employment Tax Incentive Act No. 26 of 2013 makes the application of the ETI by an employer who meets the stipulated criteria automatic. This automatic triggering of the incentive rather than having an administrative approval to apply the incentive makes it more transparent²⁸⁴.

Further the law clearly and specifically stipulates for the administration of the ETI. For instance, section 5 of the Employment Tax Incentive Act No. 26 of 2013 provides for the penalty for displacing an employee against whom the employer claims on the incentive. The section also provides what would

²⁸¹ See note. 42 p. 1501 para 4.

²⁸² The Employment Tax Incentive Act No. 26 of 2013.

²⁸³ Based on section 3 of the Employment Tax Incentive Act No. 26 of 2013 an employer is eligible to apply the Incentive where they are registered for withholding and payment of employees' tax, they are not the government (as defined) or a disqualified person (as defined).

²⁸⁴ See note. 42 p. 1501 para 4.

constitute a displacement that would attract such a penalty. Overall, the law contains most of the administration framework of the incentive rather than leaving it to the discretion of tax administrators. The proposed incentive could adopt a similar approach.

6.3.2 *Practical effectiveness*

From the design of the ETI an employer makes a higher claim in the first year of employment. The claim then decreases in the second year of employment²⁸⁵. Moreover, the allowed claim under the employment tax incentive scheme does not exceed a certain wage²⁸⁶. Arguably, the amount of effective tax that constitutes an incentive to an employer is significantly low considering that the ETI applies in the first year when the wage paid is potentially low. This might put into question the extent of the benefit that an employer actually enjoys. The proposed incentive should intentionally aim at providing a real incentive to employers.

Furthermore, some important non-tax related aspects affect the practical effectiveness of the ETI. In one case, the minimum wage limit within the manufacturing sector is higher than the upper limit of the ETI²⁸⁷. This means that employers in the manufacturing sector are not able to use the ETI. This is an example of labour laws affect the effectiveness of the incentive. The proposed incentive should consider other laws that might affect its effectiveness and align them to the objective of human capital accumulation. Alternatively, the incentive should consider the operation of other laws and go round any restrictions imposed under those laws.

²⁸⁵ See note. 101 p. 3 para 1 et. seq.

²⁸⁶ See note. 101 p. 3 para 1 et. seq.

²⁸⁷ De Jongh J, Meyer N and Meyer D, 'Perceptions of local businesses on the employment tax incentive act: The case of the Vaal Triangle Region' 2016 (13) *Journal of Contemporary Management* p. 426 para 1.

Another instance where the ETI might fall short on practical effectiveness is in that the ETI does not consider all the needs of the employer. For instance, some employers can only operate with people that possess specialized skills or certain experience e.g. skills to operate specialized equipment²⁸⁸. Ideally, the government should also support such employers. The government could, for instance, provide technical training through the Sector Education Training Authority to young employees to enable them to be absorbed in sectors that require some specialized skills²⁸⁹. This different approach could be a form of incentive. Engaging employers to understand their needs will help to make the proposed incentive practical.

6.3.3 *Design and evaluation*

The objective of the ETI is to encourage employment creation²⁹⁰. The employees who the ETI aims to create employment for are those between the ages of 18 years and 29 years²⁹¹. The law also provides the maximum wage upon which an employer can claim the incentive which is adjusted annually for inflation²⁹².

Notably, some aspects of the design of the ETI are plausible. One such aspect is the provision on roll-over of claims to the subsequent month where the amount of the tax incentive exceeds the tax payable for the month²⁹³. Another plausible aspect is the provision for reimbursement of excess tax incentive if it is not claimed in succeeding months²⁹⁴. These two provisions ensure that even employers with tax overpayments benefit from the incentive which makes the incentive impactful. Furthermore, the law provides for evaluation of the ETI

²⁸⁸ See note. 287 p. 246 para 2.

²⁸⁹ See note. 287 p. 246 para. 3.

²⁹⁰ Section 2(1) of the Employment Tax Incentive Act No. 26 of 2013.

²⁹¹ Section 6(a) of the Employment Tax Incentive Act No. 26 of 2013.

²⁹² Currently, the incentive may be claimed for employees earning wages below R. 6,500.

²⁹³ Section 9 of the Employment Tax Incentive Act No. 26 of 2013.

²⁹⁴ Section 10 of the Employment Tax Incentive Act No. 26 of 2013.

and information on the ETI is required to be published twice a year²⁹⁵. The proposed incentive could copy these aspects.

While the design of the ETI has many positive aspects, some aspects like capping of the maximum amount of wage against which the incentive may be claimed may limit its use. The proposed incentive should consider the impact of any caps which are imposed. Furthermore, the incentive should as far as possible try to align itself to other laws.

6.3.4 *Cost effectiveness*

The idea of cost effectiveness is that the foregone tax revenue and other costs should be less than the benefit of the incentive. In this case, the objective of the ETI is to increase employment. In the short run the ETI did not produce any significant positive effect in the reduction of unemployment among the youth²⁹⁶. It would appear that in the short run the employers who were benefiting from the incentive were the employers who would have employed the particular focus employees in any case²⁹⁷. The recent information on the ETI provided by the National Treasury in September 2019 however indicates that there has been positive benefits from the ETI especially in the small firms²⁹⁸.

From the government perspective it would appear that the ETI is achieving its objective and the foregone revenues are worthwhile²⁹⁹. The government has reported significant benefits even if other studies find that the benefits of the ETI are not substantial³⁰⁰. Thus, the question of how cost effective the ETI is remains open. Nonetheless, the proposed incentive should be monitored to review for the cost and benefits associated with it.

²⁹⁵ Section 11 of the Employment Tax Incentive Act No. 26 of 2013.

²⁹⁶ See note. 220 p. 1 para 2

²⁹⁷ See 296 p. 1 para 2.

²⁹⁸ National Treasury RoSA, *Revenue trends and tax proposals* (September, 2019) p. 42 para 4 et. seq.

²⁹⁹ Ibid.

³⁰⁰ See note. 220 p. 9 para 1 et. seq.

6.4 *Conclusion*

The chapter has provided recommendations on reforms that each country needs to make in establishing the proposed direct tax incentive. This was through the evaluation of the like tax rebate system on offer in Kenya and the Employment Tax Incentive Scheme in South Africa.

CHAPTER SEVEN

7. CONCLUSION

Based on the analysis in the substantive chapters, the dissertation finds that several important considerations and reforms are necessary to establish an ideal direct tax incentive for employers in Kenya and South Africa that contributes to human capital accumulation. The subsequent sections highlight these considerations as well as the proposed reforms.

7.1 Proposed considerations

These considerations are in three parts; general considerations, specific considerations and other considerations that are neither general nor specific.

7.1.1 General considerations

Tax incentives face criticism for distorting tax systems thus, it is important that the proposed incentive does not fall into this trap. To ensure this, the ideal tax incentive should be transparent, practically effective, well designed, have an evaluation mechanism and be cost effective. While these features do not make a tax incentive full proof against potential distortionary effects, they help to mitigate against some of the common distortionary effects.

7.1.2 Specific considerations

The first specific consideration is the needs of employers who are the target group for the incentive. The two major concerns for employers who invest in employees are: mitigation of the risk of employees leaving the employers and the cost of investment. The proposed incentive should therefore seek to address these needs.

One way to deal with the concerns of employers could be through granting a real incentive. A real incentive would be a benefit that is significant or substantial. An example of a real incentive is the case of Australia that allows a

deduction of an additional 50% of training expenses with an alternative for employers in a tax loss position to take a tax credit. The proposed incentive could take a similar approach. It could also consider business sizes of employers and the number of employees engaged by an employer. This will help to establish a focused and beneficial incentive for each class of employers.

The second specific consideration is that the proposed incentive should be a success from the government's perspective. One way that the incentive could fail from the government's perspective is due to misuse by employers. An example of potential misuse would be a case of employers taking the incentive then instead of investing in all their employees they only invest in some employees. For instance, an employer could focus on developing senior employees and not develop junior employees. To address such an instance, the proposed incentive could give a higher benefit for investing in employees whom employers are likely to discriminate against. Another way the government could realize success is by targeting the incentive to sectors that need human skills like the technology sector or the creative industry. This way, the proposed incentive will bear some fruit for the government.

7.1.3 Other relevant considerations

These are other considerations that are neither general nor specific. They include:

- *Why should human capital accumulation be a primary goal of focus for the government?*

The dissertation notes that that human capital is an important factor for economic growth of a country. Human capital is important today where the knowledge economy is a key driver of wealth creation in the global economy. This being the case, the governments of Kenya and South Africa should prioritize human capital accumulation as this is necessary to participate in the global economy.

Furthermore, this dissertation observed that in the modern times there is an increased rate of employees leaving their employers after short periods of time. Hence, the risk of investment in employees has increased while the need for skilled employees intensifies. Left with no intervention, the economy stands to suffer if employers hold back on their investment to develop employees. The government should therefore see this as a reason for to intervene. The dissertation proposes use of a direct tax incentive as a form of government intervention.

Lastly, there is currently need for human skills in the Kenyan and South African markets to advance their development agendas. This being the case, the governments of both countries should find it needful to help in supplying the shortage in the market.

➤ *Which employers should be offered the incentive?*

The dissertation finds that, first, employers are an easy target for the incentive since they have close proximity to the training, development and maintaining of the skills embodied in their employees. The dissertation also finds that in practice, through the initial equipping of employees i.e. giving graduates a chance to hone their skills employers contribute to human capital accumulation. Moreover, employers who fund continuous development programs undertaken by employees contribute to human capital accumulation. Additionally, employers within a competitive market tend to take own initiative to develop their employees for their businesses to remain competitive in the market. It is based on these observations of the various roles played by employers that this dissertation concludes that there is rationale for offering a tax incentive to employers to influence human capital accumulation.

The dissertation also concludes that, as regards which employers are better to target with the incentive, the needs of the economy should take the forefront. For instance, employers within the competitive environment in manufacturing sector may not necessarily be contributing to developing skills that are needed in the creative economy. Hence, the needs of the economy should play the most significant role in the design of the proposed incentive. Nonetheless, the focus

of the incentive should not necessarily be the services sector or manufacturing sector. Rather, it should be as need dictates.

➤ *Are existing incentives sufficient to meet the desired objective?*

The dissertation finds that Kenya and South Africa have incentives that benefit employers indirectly. An example being the Special Economic Zones. While such an incentive might benefit an employer through giving a favourable treatment of employee related expenses, that is a secondary consequence. This is because the Special Economic Zones, for instance, do not pursue human capital accumulation as the primary goal.

Furthermore, the dissertation finds that each country has a narrowly targeted direct tax incentive to encourage employment of young job seekers and graduates. These direct incentives are narrow in the sense that they cannot benefit employers who invest to develop their employees in any other way over and above employing graduates or young job seekers employment for a specific period. Moreover, both countries offer deduction of employee related expenses under their respective their tax legislations. The deduction of such expenses is, however, not an incentive. Rather, the deduction is based on the business principle that argues for deducting of costs incurred in production of income. Hence, such deduction of expenses is not a special rule and therefore falls out of the category of a tax incentive.

It is then observed that, each country lacks a broad tax incentive that would benefit all employers who invest in developing their employees. Hence, the dissertation concludes that there is room for reform in both Kenya and South Africa to establish a direct tax incentive for employers that contributes to human capital accumulation.

➤ *Why should the desired tax incentive be direct?*

The dissertation finds that a direct tax incentive given to employers would reduce the cost of the investment. This would be appealing to employers in view of the fact that most employers find it risky to invest in employees since employees can leave their employers at will. Secondly, small businesses may

not have sufficient resources to invest in their employees in any significant ways.

The dissertation also finds that a direct incentive sets human capital accumulation as a priority. Currently, the contribution made to human capital accumulation by the indirect tax incentives is a secondary. This might show that human capital accumulation is not a priority for the government. A direct incentive would take away this perspective by making human capital accumulation a priority.

Lastly, the dissertation proposes that the tax incentive that contributes to human capital accumulation mimics the type of incentive given towards research and development. Hence, the proposed incentive should also be direct as is the case for the tax incentive given for research and development.

➤ *What activities constitute human capital development?*

The dissertation finds that a wide range of activities may qualify as investment in human capital. The distinguishing factor between an investment and consumption being that an investment should yield a return. The return could either be in the form of increased profits for the employer, an increase in wages for the employee or growth in the economy. Hence, the dissertation concludes that the proposed incentive should view activities which meet this criterion of yielding a return as an investment from an employer.

Furthermore, the dissertation notes that investments related to the knowledge economy ought to constitute a form investment. The proposed incentive should therefore view any activities that encourage innovation and creativity as an investment. The dissertation also finds that mental health is an important factor in the world today where mental exertion is the main ingredient for the knowledge economy. Hence, the proposed incentive ought to treat investments incurred to maintain human capital in the form of maintaining health, and especially mental health, as a form of investment.

7.2 *Proposed reforms*

The approach taken is to evaluate the current tax rebate scheme offered to encourage employment of graduates in Kenya and the Employment Tax Incentive Scheme offered in South Africa. The evaluation serves to suggest reforms or modifications that would need to be made when designing a ‘like’ direct tax incentives. These two schemes are a type of the direct tax incentive proposed by this thesis. Hence, it would do well to look out for the deficiencies identified in these like schemes and avoid them. The reforms that each country needs to make are as highlighted below.

7.2.1 *Kenya*

Employers who employ at least 10 university graduates and whose income is not wholly exempt from tax enjoy an additional deduction of 50% of the wages paid to the graduates. The design of the tax rebate falls short in a few aspects. It is suggested that the proposed incentive should improve on these areas. These are highlighted below.

➤ *Transparency.*

An identifiable issue on transparency is that employers are required to first seek consent from the Director General of the National Industrial Training Authority before they engage graduates’ apprentices. It is however not clear what the Director General is required to evaluate to give the written consent. It would thus appear that the consent is at the discretion of the Director General. Such discretionary power in relation to a tax incentive may lead to corruption making the incentive ineffective.

A possible reform in this case is for the proposed tax incentive to be triggered automatically where a person meets the qualifying criteria. For instance, once an employer engages the minimum number of employees, they should automatically apply the rebate. The employer should however be able to demonstrate, if required, that they met this qualifying criterion. The law could

then prescribe a penalty for employers who fail to demonstrate that they met the qualifying criteria to enjoy the incentive.

➤ *Practical effectiveness*

The dissertation finds that the incentive provided by the rebate is comparatively less than the training and input that employers would invest into the graduates. Additionally, the rebate being a deduction of an additional tax expense would not immediately benefit employers in tax losses.

A proposed reform is that employers get the option to claim a tax credit if they are in tax losses so that to realize an immediate benefit. Secondly, the amount of incentive offered should be relative to the investment for it to be appealing to employers. Lastly, other non-tax factors like the general business environment which affect the economy should be considered for the proposed incentive to be practically effective.

➤ *Design and evaluation*

A key short fall of the rebate system is that employers whose income is tax exempt cannot use the incentive. This design loses sight of the fact that such tax-exempt firms are also employers. If the rebate system was more efficient, such employers could possibly be allowed to get a cash refund for engaging the apprentices. Moreover, the design of the incentive does not seem to take into consideration the need to mitigate against the risk of investing in graduates.

The proposed reform in this case is that the design of the incentive should cater to all employers whether they are tax exempt or in a tax loss position. The qualifying criteria should be that someone is an employer. Hence, unless there is a sector specific target for developing certain skills, there should not be exemption of some employers from enjoying the incentive. Additionally, the

incentive should as far as possible, provide a substantial and significant incentive to address the risk factor.

➤ *Cost effectiveness*

Observably, the issues identified around the design of the rebate system may reduce the benefit of the incentive. Furthermore, there is no clear evaluation mechanism by the government to monitor whether the benefit of the incentive outweighs the cost. As part of reform, this aspect of evaluation should be considered in the design of the proposed incentive.

7.2.2 *South Africa*

➤ *Transparency*

To a great extent, the administration framework of the Employment Tax Incentive is provided under the law. Hence, tax administrators do not have much room to exercise discretion. Some aspects of the design are plausible for instance, the automatic triggering of the incentive once the employer self-determines that they have met the stipulated criteria. Additionally, penalties for not complying with the provisions around the incentive are provided in the law leaving out need for constant monitoring of employers by tax administrators. The proposed incentive should be developed along these plausible aspects.

➤ *Practical effectiveness*

Under the Employment Tax Incentive scheme, an employer makes a higher claim of the tax credit in the first year of employing a job seeker. The claim then decreases in the second year of employment. Moreover, the allowed claim should not exceed a certain wage. This design means that the employer obtains a capped amount of incentive due to the wage limit. This is while the level of training and development offered to the employee is likely to be higher than the capped benefit.

Further, some important non-tax related aspects affect the practical effectiveness of the incentive. For instance, the minimum wage limit within the manufacturing sector is higher than the upper limit of the incentive. Also, in some cases some employers can only operate with people that possess specialized skills or certain experience. Hence, such employees cannot enjoy the incentive.

The dissertation proposes some reforms to deal with some of the potential disadvantages arising from the design of the incentive. First, an incentive aimed at developing long term skills should increase rather than decrease and should not have a cap on the wage. The idea being that an employer should be able to develop and train an employee and benefit by claiming an incentive on the high wage that an employee will receive as a result of the training and development. Additionally, non-tax matters like the review of the impact of labour laws that stipulate minimum wage should be done when designing the proposed incentive. Furthermore, in designing the proposed incentive for human capital accumulation, it will be important to understand the needs of employers. It is therefore important to engage employers in the design of the incentive to make it practical to them.

➤ *Design and evaluation*

The dissertation concludes that the needs of an employer should guide the design of an incentive. As regards evaluation, the proposed incentive should have target milestones to ensure there is accountability. This will also give room for review of the aspects of the incentive that might be negatively affecting its success.

➤ *Cost effectiveness*

The proposed tax incentive should target employers who would not undertake the proposed investment activities. This will help to avoid granting the incentive

for activities that employers would undertake without any incentive. This will make the incentive cost effective. Monitoring of the incentive will also help to identify whether it has influenced employers who would not have undertaken the activities which it seeks to encourage.

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