

# SOUTH AFRICA'S EMPLOYMENT TAX INCENTIVE

Can a wage subsidy tackle the world's third highest youth unemployment rate?

**Development Policy Research Unit (DPRU), University of Cape Town**  
**JustJobs Network**

## **Development Policy Research Unit (DPRU)**

The Development Policy Research Unit (DPRU) has been actively engaged in policy-relevant socio-economic research since 1990, establishing itself as one of South Africa's premier research institutions in the fields of labor markets, poverty and inequality. The DPRU is a University-recognised research unit located within the School of Economics at the University of Cape Town. Through the application of economic and statistical techniques, DPRU's aim is to produce academically credible and rigorous policy analysis.

*JustJobs Network is a co-author of this chapter*

# SOUTH AFRICA

125/148

JustJobs Index Ranking



51.8%  
Labor Force  
Participation



26.1%  
Youth Labor Force  
Participation



25%  
Unemployment



52%  
Youth  
Unemployment

**Source:** These data are ILO modeled estimates provided by the World Bank. Individual authors may use national estimates.

## Challenge

*South Africa faces the third highest youth unemployment rate in the world, due to high labor costs, a massive skills gap and vulnerability.*

## Strategy

*The Employment Tax Incentive (ETI) is a wage subsidy scheme meant to incentivize firms to hire more young people by offsetting the cost. If the challenges around awareness and compliance costs can be overcome, the impact of the program on newly hired young people would be significant.*

# SOUTH AFRICA'S EMPLOYMENT TAX INCENTIVE

## Can a wage subsidy tackle the world's third highest youth unemployment rate?

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Youth unemployment in South Africa has reached a critical high. At 52 percent,<sup>1</sup> the country faces the third highest youth unemployment rate in the world,<sup>1</sup> only behind Spain and Greece.<sup>2</sup> Almost 72 percent of unemployed South Africans are under 34 years of age.<sup>3</sup>

In terms of human capital, only 14 percent of young people hold tertiary degrees<sup>4</sup> – one of the best assurances of employment<sup>5</sup> – and those obtaining Further Education and Training (FET) often face a skills mismatch that renders them unemployable in sectors that offer high-quality jobs. Meanwhile, demand-side issues exacerbate labor market

woes for youth, with too few employers looking to hire young people.

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***“South Africa faces the twin challenge of implementing structural reforms to enable better labor market outcomes for its young people over the long-term, while at the same time getting a large number of youth into jobs immediately.”***

labor market outcomes for its young people over the long-term, while at the same time getting a large number of youth into jobs immediately. Ensuring sharper alignment of skilling programs with labor market demand and removing barriers that prevent the growth

of small businesses is critical in the long run. However, the current social epidemic must be addressed, too, with policies that have a quicker

<sup>1</sup> This statistic refers to the share of the labor force ages 15-24 without work but available for and seeking employment.

turnaround. The scale of joblessness among youth is seen as a potential threat to social and political stability.<sup>6</sup>

As a response to this youth unemployment challenge, the government of South Africa passed the Employment Tax Incentive Act (ETI) in 2013, a firm-side subsidy aimed at encouraging employers to hire youth. This subsidy could complement other policies targeting unemployment such as the Expanded Public Works Program, which created 3 million jobs between 2009 and early 2013.<sup>7</sup>

This chapter analyzes the specific challenges that youth face in the South African job market and assesses the ETI as a strategy for tackling those challenges. It tracks early indications of the degree of success the scheme may achieve in helping young people access better quality employment. Further, the chapter considers how the youth wage subsidy must be part of a larger youth job creation strategy and proposes steps forward to ensure the sustainability of the program's impact.

## A market emerges, but leaves behind youth

While South Africa's growth rate, like that of other emerging economies, was weakened by the financial crisis – dropping from a high of 5.6 percent in 2006 to an average of less than 2 percent over the last five years – the country has retained its position as an investment destination in Africa. From 2007 to 2012, during the crisis, the number of FDI projects in South Africa grew at a compounded annual rate of 22.4 percent.<sup>8</sup>

However, this investment has not translated into jobs for the growing numbers of young workers in South Africa. From 2008 to 2012, the unemployment rate among youth aged 15 to 24 grew from 45.6 to 52 percent.<sup>9</sup> As of 2013, about

3.3 million young people were out of work and actively looking for a job. Of the South African population that is unemployed, 44 percent have never worked before, demonstrating the enormous difficulty youth without work experience face in penetrating the labor market.<sup>10</sup>

### ***High labor costs and the apartheid legacy***

One of the fundamental issues in South Africa's labor market is the lack of demand for young workers among employers. There are myriad causes. For one, a strong culture of trade unionism has produced positive effects for those already employed, with a wage premium and strong social protections. The high cost of employment

can act as a disincentive to hire inexperienced workers, who in turn struggle to get their foot in the door.<sup>11</sup> Without an entry point, young people lack critical job experience.

Meanwhile, South Africa's apartheid history plays a role in the spatial distribution of jobs and the formation of the information networks most people use to find work. Blacks in South Africa – who are unemployed at a much higher rate (55 percent among black youth)<sup>12</sup> live far from business centers and are often disconnected from word-of-mouth information on employment opportunities.<sup>13</sup>

#### ***A weak small business sector***

Small businesses in many economies are an engine of job creation, but in South Africa the sector is limited. Small and medium enterprises (SMEs) provide approximately 70 percent of national employment in South Africa, but 50 percent of those businesses fail within the first two years, and 67 percent provide no employment to anyone beyond their owners.<sup>14</sup> South Africa had only 38.8 micro, small, and medium enterprises per 1000 people in 2004, much behind other upper-middle-income countries like Chile (60.2) and Hungary (47.8). In addition, a meager 8.3 percent of these businesses were in the labor-intensive manufacturing and processing sector.<sup>15</sup>

A lack of entrepreneurship – exacerbated by credit constraints – and a lack of geographical access to

potentially lucrative markets combine to weaken the SME sector.<sup>16</sup> As a result of their stunted growth, small businesses have limited scope for absorbing the vast numbers of unemployed youth.

A related factor and one of the idiosyncrasies in South Africa's labor market is its minuscule informal sector. The share of persons employed in the informal sector in total non-agricultural employment stood at 17.8 percent in 2010, compared with 67.5 percent in India and 60.2 percent in Indonesia.<sup>17</sup> Large informal sectors in other emerging markets absorb a large number of young workers – albeit in suboptimal working conditions and with few protections. In contrast to countries like Brazil that have made formalization of employment a clear policy priority, South African policy on the informal sector has not taken one single direction; some measures seek to grow the informal sector to curb unemployment, while others attempt to formalize the informal sector to protect workers. The lack of policy consistency has not promoted the informal sector as a tool to absorb the unemployed.

#### ***The skilling challenge***

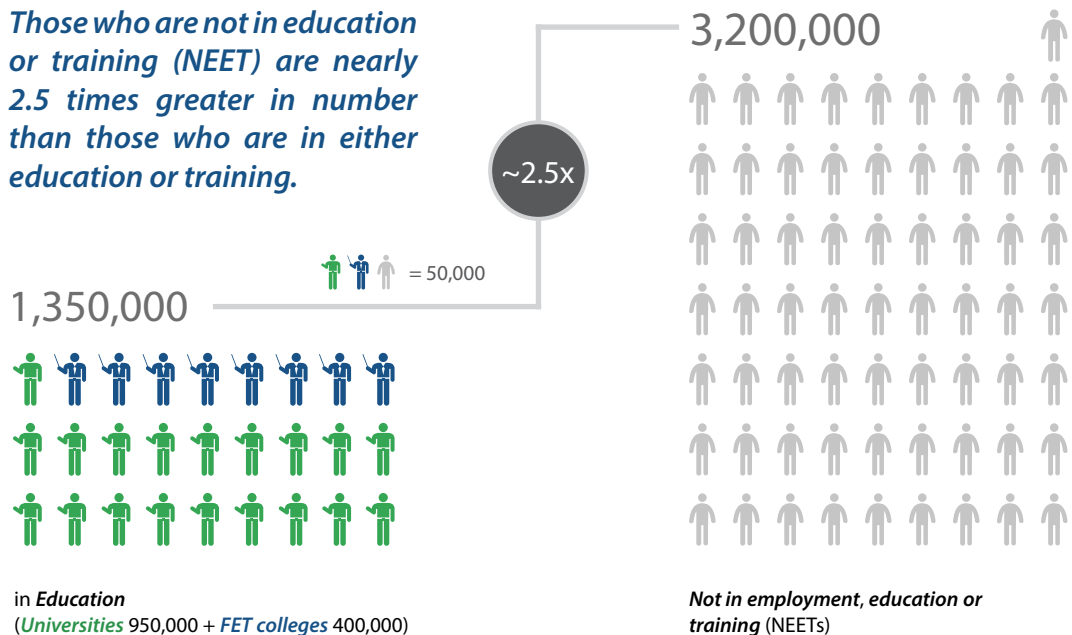
South Africa's supply side challenges to youth employment are equally, if not more, severe. Those with tertiary education in South Africa are the most likely to find employment. They represent 17 percent of the labor force but only 5.8 percent of the unemployed.<sup>18</sup> Nevertheless,

the country's tertiary educated youth – most suited for sectors such as finance, banking and engineering – still face an uncertain future. While still performing better than other sectors, annual growth of the services sector reached a five-year low of 2 percent in 2013.<sup>19</sup> As greater numbers of young people choose to pursue tertiary education (950,000 were enrolled in 2010),<sup>20</sup> reviving the service sector is an imperative.

students were enrolled.<sup>21</sup> Their competitiveness in the labor market for high-quality jobs depends on the capacity of these institutions. FET colleges have, up until now, experienced low graduation rates, inadequately qualified lecturers and insufficient industry-linked experience. The government plans to improve completion rates, student services, and infrastructure with an aim to offer programs more relevant to the needs of employers.<sup>22</sup>

About 570,000 young people are in FET – a dramatic increase since 2009, when only 200,000

*Those who are not in education or training (NEET) are nearly 2.5 times greater in number than those who are in either education or training.*



in Education  
(Universities 950,000 + FET colleges 400,000)

Not in employment, education or training (NEETs)

Source: CJ Sheppard and N. Cloete 2009. Scoping the Need for Post-School Education. (Cape Town: CHET)

Amongst the unemployed in South Africa, those who are not in education or training (NEET) are two and a half times greater in number than those who are in either education or training.<sup>23</sup> Youth who fall into the NEET category face the most pressing challenges because of their massive numbers and low skill levels. While the agricultural sector may have had the capacity in the past to absorb low-skilled youth, it has seen negligible growth in the last five years. Total employment in the sector has diminished from 9.1 percent in 2004 to 4.6 percent in 2011.<sup>24</sup>

#### ***Vulnerable employment***

Aside from the lack of jobs and the skill mismatch between employers and job seekers, quality of work remains a challenge as well. The mining industry, for instance, has become notorious

for disruptions in the form of strikes and worker unrest. In 2012 alone, mining sector workers called 17 national strikes.<sup>25</sup> These workers face a range of health and safety hazards, such as falling rocks, exposure to dust, intensive noise, fumes and high temperatures.

South Africa does have a comprehensive legislative posture towards occupational hazards, but lacks the resources to enforce compliance. Besides mining, other sectors that employ low-skilled workers such as iron and steel, chemicals, transport, agriculture and forestry, building and construction, and foods, drink and tobacco manufacturing have been identified as high-risk industries by the South African Department of Labour.<sup>26</sup>

## The employment tax incentive

This section outlines a program of the South African government aimed at addressing the lack of demand for young workers. The Employment Tax Incentive (ETI) is a wage subsidy scheme meant to incentivize firms to hire more young people by offsetting the cost. For workers aged 19 to 29 earning between R 2000 and R 4000 (US \$187-374) per month, the government will pay R

1000 (US \$94) per month directly to the employer. For a worker earning above R 4000, the subsidy decreases, and it does not apply to anyone earning above R 6000 (US \$561) per month.

Businesses can avail the subsidy for two years per employee, though the amount decreases by half in the second year. While the ETI Act lacks a direct

link to skills training programs, the government expects that on-the-job experience will develop market-aligned skills in its youth workforce.

In February 2011, the South African Treasury published a projection that estimated the ETI scheme will create 178,000 new jobs over three years, at a cost of R 28,000 (US \$2,600) per job, costing R 5 billion (US \$464.7 million) to the exchequer.<sup>27</sup> The proposal also took into account dead-weight losses that would amount to accruals to employers who have already hired approximately 423,000 young employees in the absence of the subsidy.

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Other countries have also experimented with youth wage subsidies. Chile rolled out a subsidy targeted specifically at youth from poor backgrounds, and Colombia’s program is available specifically to small businesses.<sup>28</sup> Spain has introduced a program that involves social partners, public administrators and private sector stakeholders, offering a subsidy not only for employment, but also apprenticeship and training programs.<sup>29</sup> Australia, too, has linked its subsidy program directly to skill development.<sup>30</sup> In addition, Argentina, Bulgaria, Czech Republic, Kyrgyzstan, Mexico, Poland, Slovakia, South Korea, Switzerland, Sweden, and Turkey all have some form of a wage subsidy program.<sup>31</sup>



## Potential impact: Progressive policy or regressive tax?

The ETI came into effect in January 2014, amid much debate in South Africa's civil society and business community around the program's potential effects and implications. A couple factors make it difficult to evaluate the wage subsidy at this stage. First, the program has only been in place for nine months. Awareness of the scheme, especially among small businesses, appears to be one of its major challenges,<sup>32</sup> so the number of businesses hiring or planning to hire subsidized workers may change significantly once knowledge of the program spreads. Second, it is not possible to predict the South African labor market's response to a wage subsidy based on other countries' experiences; as the International Labour Organization (ILO) notes, "success of a wage subsidy can be context specific and depends on the nature of the intervention and the structure of the labor market."<sup>33</sup>

Nevertheless, some early indications point to the potential uptake among businesses, the possible impact on youth who are hired under the subsidy, and the challenges that may limit the program's success.

### ***Interest among employers, but hurdles on compliance***

According to then Minister of Finance Pravin Gordhan, the program recorded 56,000 beneficiaries in its first month of inception.<sup>34</sup>

In a poll conducted earlier this year, 41 percent of large businesses said they were considering hiring young people to avail the subsidy. Among small businesses that were aware of the program, 60 percent are considering hiring youth under the subsidy.<sup>35</sup>

The poll also revealed two major obstacles the scheme faces. The first, as mentioned, is awareness, especially among small businesses. The second, and perhaps larger challenge, relates to tax compliance. In order to qualify for the subsidy, businesses must register their payrolls with the PAYE ("Pay-As-You-Earn") income taxation system.<sup>36</sup> Right now, 64 percent of small businesses are not registered with the PAYE system, and the costs of doing so may outweigh the benefits of the subsidy.<sup>37</sup> Overcoming this hurdle is important, since SMEs must play a critical role in South Africa's effort to reduce youth unemployment.

### ***A long-term solution for young people?***

A randomized control trial conducted by the ILO sheds light on the potential impact of the program on long-term employment outcomes. In the study, young South Africans hired through a wage subsidy were about 25 percent more likely to be in wage employment after the expiration of the subsidy than the control group – both one year and two years following expiry of the voucher.<sup>38</sup>

These findings suggest that, if the challenges around awareness and compliance costs can be overcome, the impact of the program on newly hired young people would be significant.

Using the ILO study as a basis, another impact evaluation predicts that the ETI will create 88,000 new jobs – that is, jobs that outlast the subsidy itself. The evaluation estimates that the cost per job created through the ETI would still be less than the cost per job created by the Expanded Public Works Program, another of South Africa’s major employment schemes.<sup>39</sup> The scale of job creation, however, is far greater in the case of the latter program, which has created 3 million jobs since 2009.

#### ***Civil society’s concerns***

One of the central concerns voiced in civil society is regarding impact of the subsidy on older workers. Trade unions in particular have predicted this outcome, saying older people will lose their jobs to subsidized young workers.<sup>40</sup> This concern may be exaggerated, however, as one poll of employers found that only 27 percent would consider replacing older workers with a younger, subsidized employee.<sup>41</sup>

Others suggest that the scheme will simply subsidize existing workers who are within its scope or those in new jobs that would have been created anyway – resulting in a handsome tax break for employers with little to no impact on the youth unemployment epidemic. However,

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because the subsidy is implemented through the tax system, the scale of targeted businesses is larger and therefore the program may be taken up more broadly than employment programs previously introduced.

#### ***The international experience***

The impact of wage subsidies internationally has been mixed. Argentinean and Australian youth hired under a wage subsidy were significantly more likely to be employed 18 months to two years following the expiry of the vouchers.<sup>42</sup> In Turkey, the program increased the number of jobs by an estimated 5 to 15 percent and played a major role in increasing registration of firms. But wage subsidies in countries like Czech Republic and Poland have had a negative effect on the earnings of program participants after the subsidy expires. Several countries have faced administrative challenges in implementation.<sup>43</sup>

Several countries implementing wage subsidy programs have evolved mechanisms for overcoming the potential pitfalls of the policy tool. In Chile, for instance, the employer does not know which workers are subsidized, eliminating the potential for a substitution effect.<sup>ii</sup> The

linkages to skill development in countries like Australia increase the likelihood that improved employment outcomes will be sustained in the long run. To preempt a backlash from trade unions, Spain involved them in the process of policy design and implementation.

## Conclusion

The ETI is an important measure to curb high youth unemployment in the short run, and it is likely that the program will open doors for young people to enter the labor market and become more employable. However, it is by no means a panacea for South Africa's youth entering the labor market. The ETI must be linked to strategies that include up-skilling South Africa's youth, growing small businesses and promoting labor-intensive sectors if it is to have the desired impact of improving youth employment outcomes in the long term.

To this end, policymakers should increase awareness of the scheme among small businesses and ensure that the cost-benefit analysis for

these enterprises is in favor of participation. Most importantly, South Africa must explore ways to link the subsidy with skill development more directly – for instance, by offering a skilling component to program participants aligned with their occupation. In this way, the ETI can serve another goal – strengthening the linkages between labor market demand and vocational training – and its impact can be more sustainable.

Through close evaluation and tracking of the program's success as it evolves, South African policymakers can ensure that the ETI is contributing positively to a larger policy architecture aimed at lifting young people out of joblessness.

<sup>ii</sup> *The program in Chile targets youth from poor backgrounds. In the case of South Africa's program, an "employer-blind" system would be impossible.*

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