COMMENT ON THE TAXATION LAWS AMENDMENT BILL, 2001

(to incorporate the taxation of capital gains)

Part 1 – Comment on the Bill

1. Capital Gains Tax and South Africa

Capital Gains Tax (CGT) is too complex and costly for South Africa. The original intention was no doubt to tax the wealthy who avoid income tax by ensuring that their gains are of a capital nature and not subject to income tax. However, the Bill imposes CGT on the gains of people of modest means. Those South Africans who were prevented from earning capital gains in the past are to be subjected to this “first world” form of taxation at the very time when they have gained the freedom to invest and accumulate assets. The tax is also being imposed at a time when the “first world” is coming to the realisation that CGT imposes an unacceptable economic cost in the form of taxpayer compliance costs, rigidities caused by people being reluctant to dispose of assets, a reduction in entrepreneurial activity, high enforcement costs and the loss of foreign investment.

The imposition of the tax in the manner described in the Bill is bound to have unfortunate consequences for the economy. Taxing inflation gains is patently inequitable and will drive away investment.

Another worrying factor regarding the Bill is the lack of consideration it shows for those who are not wealthy – those middle to lower income people who do not understand the complexities of taxation. Very few South Africans, including the highly educated, understand our complicated tax laws and are capable of complying with them without skilled professional assistance. The fiscus should aim at simplifying the laws and not complicating them even further by introducing a tax of this nature.

The following factors need to be taken into consideration:

- **Capital Gains Tax cannot be dealt with in isolation**

This comment assumes that South Africa's overall fiscal and taxation policies are designed to bring about the highest possible economic growth and the most rapid improvement in the economic welfare of all the country's people. If that is so, the introduction of this additional tax is not the way to achieve the assumed objective. It will not be in the best interests of the country's citizens and especially not the citizens that have been prevented from accumulating capital in the past.

- **CGT adds to the complexity of South Africa’s tax system**

The introduction of capital gains tax, which is a complex form of tax, will make South Africa's tax laws even more incomprehensible to the average taxpayer than they are already. It will be a windfall for the tax lawyers and accountants who will be hired to minimise the effects of the tax, especially on the wealthy, and will impose enormous compliance costs on citizens, including those with very modest means. CGT will also impose high policing costs on the state, considerably reducing the net revenue the tax is supposed to earn. Figures from other countries show that the cost of the harm to the economy is likely to be greater than the amount of tax collected.

- **CGT will cause major distortions**

The introduction of a capital gains tax as an add-on to the taxes we already have will cause major distortions in the economy. Investors will adapt their behaviour to avoid paying the tax and the effects on the economy will necessarily be negative.

- **The CGT proposals make no provision for eliminating inflation price increases**

Taxation of pseudo-profits arising exclusively from inflation price increases will amount to a tax on savings and original capital and not on gains. Price increases arising from inflation are not "profits". Calculated gains should be reduced to real terms by adjusting them by the CPI; only then can real gains be established.

The proposals in their present form are inequitable. South Africa's monetary authorities are directly responsible for inflation. The inflation they create erodes the purchasing power of savings and impoverishes pensioners and the aged whose life savings dwindle away. Inflation is therefore a tax on savings. The Bill in its present form is designed to compound the problem by directly taxing the pseudo-gains resulting from inflation that are realised by people who attempt to protect themselves from its pernicious effects.

Those people who are able to avoid the worst effects of inflation by holding assets do not make gains. They merely avoid the worst effects of the decline in the purchasing power of the rand. The quotes from the UK and Canada in your *Guide to Capital Gains Tax* are factually incorrect, as they do not take account of the inflation-effect.

2. An example showing why the tax in its current form is inequitable

A person who invests R60 000 in a unit trust for twenty years and is eventually paid out an amount of R230 000 could face CGT on R170 000 after deducting the base cost of R60 000. The inclusion in the income of such an individual would be (25% of R170 000 less R10 000) or R40 000. The taxation of this "gain" which is an average of 7% per annum would clearly be inequitable because the Bill makes no provision whatsoever for the erosion of the value of money by inflation. (N.B. The average inflation rate over the past twenty years has been well above 7% per annum.) The investor would be suffering a loss in real terms yet be required to pay tax on an apparent "gain" that is solely due to inflation. (*See Proposal 5.1 on Page 4*).

A taxpayer with the foregoing investment could be a person with relatively modest means and the proceeds of the investment could represent their life's savings. Such persons should be exempted from the ambit of the Bill. (*See Proposal 5.2 on Page 4*).

Another inequitable anomaly in the Bill is the failure to spread the gain over the period during which it has accrued. A capital gain earned over a period of twenty years is treated in the same way as a gain earned over one year. This means that a person earning capital gains of R10 000 per annum for ten years (none of which would be taxable) receives preferential treatment as compared to a person earning a single gain of R100 000 after holding an asset and incurring holding costs for twenty years. (*See Proposal 5.3 on Page 4*).

3. South Africa is a developing country

South Africans tend to be proud of the so-called "first world" component of their economy and go along with the notion that "international best practices" should be adopted. They consequently fall into the trap of burdening the citizens with taxation, legislation, regulations and administrative systems that the country's people do not understand and can not afford.

South African society at present is still characterised by extreme disparities in wealth, standards of living and levels of education. A minority of the population, mainly white, is as economically advanced as any group in the world, but the majority, mainly black, is poor and ill-educated. Within this majority it is estimated that around 40% of all adults are illiterate, yet despite this many hundreds of thousands of them are running their own businesses as hawkers, taxi operators, spaza shop owners, traditional healers, artisans, small farmers, small manufacturers and so on. These are the people who are building the economy of the future and the legal, taxation and administrative systems of the country should be designed to accommodate them and not be designed to cater for the privileged few.

When the United States of America, other Western countries and the so-called Eastern "tigers" were at South Africa's level of development they did not have our complex laws, high taxes and large administrations. Their total government outlays (at all levels of government) amounted to no more than 15% of GDP (1960: Japan 17,5%, Switzerland 17,2% and Spain 13,7%) whilst their growth rates were well above 6% per annum. South Africa's policies should be fashioned to suit the country's level of development and should not follow every regulatory trend that is adopted in wealthier countries. In fact, South Africa should now be emulating the systems that were in place in the developed countries at the time they were at South Africa's current level of development. These countries are themselves discovering that high government expenditure and high taxes are detrimental to the long-term interests of their citizens and are seeking ways and means to reduce expenditure so as to improve economic growth.

4. The case for reducing taxes

Taxation is inextricably linked to government spending. Sooner or later, all the money government spends has to be taken from the people by way of taxes of one sort or another. Many studies over many years have shown, however, that if a government takes too much, economic growth declines, especially when the excess is spent on non-core functions. In a study published in April 1998 by the Joint Economic Committee of the US Congress, the core functions of government were identified as:

- The protection of individuals and their property.
- The enforcement of contracts.
- The maintenance of a stable monetary regime.
- National defence.
- The provision of infrastructure such as national roads, and sewage and sanitation facilities.
- Environmental protection.

In 1960, the US government's share of the American economy was 28.4%. By 1996 it had risen to 34.6%. The authors of the study claim that if it had remained at the 1960 level, the average American family of four would have been better off by $23 440 (roughly R175 000) per year. Even more startling, they also claim that if the average annual growth rate of the US economy for the period from 1870 to 1990 had been just 1% lower than it was, the per capita incomes of Americans would now be about the same as those of their Mexican neighbours. It is worth reflecting on the fact that at the end of the Second World War, the average incomes in Japan and Taiwan were about the same as those in South Africa. But the two Asian economies achieved consistently higher growth rates than South Africa and the prosperity of their citizens now, compared to ours, is plain for all to see. Such is the power over a generation or two of compound growth rates, or the lack of them, and such is the cost of wrong economic policy choices.

The US study examined the economic records of the OECD countries for the 36 years from 1960 to 1996. A direct correlation was found between the size of government and the growth of real GDP. Where OECD countries confined government spending to less than 25% of GDP, growth rates averaged 6.6% per annum. At the other end of the scale, the economies of countries with high-spending governments grew by only 1.6%. A similar study, recently published by the cross-party think-tank, the European Policy Forum, reached similar conclusions – low taxes boost economies. In 1980 government expenditure as a proportion of GDP in South Africa was already high at 30.1%. By 1995 it had reached 37.0%. The country's per capita GDP shrank by an average 1.2% per annum during this period and a total of 15% in real terms. It is now back to where it was 30 years ago.

If our people were already enjoying a comfortable standard of living, we would not have to be so concerned about growth rates. But the fact is that the majority of our people are poverty-stricken. The evidence is compelling that if we want growth rates of 6% or more we will have to reduce government spending to 25% or less. Lower spending will facilitate lower taxes. Lower taxes encourage people to work harder and smarter, to innovate, to spend, to save and to reinvest in the growth of their own businesses. As the small firms sector begins to thrive, unemployment will fall, and so will crime. As more people are employed and more small firms are established and grow, total tax collections will increase even though tax rates remain lower. Greater tax receipts will enable the government to improve the delivery of its essential core services.

5. Proposals for the mitigation of the inequities contained in the Bill

The inequities contained in the Bill could be addressed by the inclusion of the following provisions:

5.1 Inflation adjustment

We propose that government annually publish an inflation factor by which the base cost of an asset is to be adjusted in the determination of a capital gain on the realisation of the asset. The annual R10 000 exclusion could then be dispensed with.

5.2 Exempting taxpayers with modest assets from CGT

Capital gains tax is generally intended to be a tax on the wealthy who are able to make real capital gains (in excess of inflation) and increase their wealth whilst avoiding income tax. However, the Bill under discussion will tax people with very modest assets and relatively modest incomes. The cost of administering CGT, and especially compliance costs, would be reduced considerably by confining the tax to the real gains of the wealthy.

We propose that individuals with total "non-excluded" assets of less than R1 million (to be adjusted annually for inflation) be exempted from CGT.

5.3 Holding costs of assets

The Bill should make provision for the length of time that a taxpayer has held an asset, especially if there is no inflation adjustment.

It is proposed that capital gains as determined in accordance with the provisions of the Bill should be reduced by 10 per cent per annum for every completed year the asset has been held.

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Part 2 – An alternative tax system

THE FLAT TAX

Government should aim at reducing compliance costs and minimising the economic distortions caused by taxes. Taxes change the behaviour of citizens and tax systems should therefore be designed so as to have the least negative effect on their behaviour. South Africa's existing tax system could be made more citizen-friendly by introducing the following changes:

1.1 Reducing the complexity of the tax system by way of fundamental reform and simplification

If, for instance, the Flat Tax system developed and refined by the economists Robert E Hall and Alvin Rabushka of the Hoover Institution, USA, were to be introduced, the change would encourage savings, investment and entrepreneurial activity. It would reduce compliance costs, reduce tax avoidance and evasion, and would tax real capital gains much more effectively than the proposed new system. Most importantly, it would simplify South Africa’s tax system to such an extent that it would be understandable to the vast majority of taxpayers

The Hall/Rabushka Flat Tax system taxes all income at a low flat rate and has various features that reduce complexity:

- A generous personal allowance that exempts the poor from income tax.
- Two postcard-size tax returns, one for Business Tax and another for Individual Wage Tax.
- An integrated system applying the same rate to businesses and individuals, removing the incentive to utilise companies and Close Corporations to reduce tax.
- Consumption is taxed whilst saving is not.
- There are no special allowances.
- Fringe benefits are not deductible by businesses or taxable in the hands of employees.
- Interest is not deductible as a business expense or taxable in the hands of recipients.
- A 19% flat rate in 1995 would have raised the same amount of federal revenue for the American government as the existing complex system.
- The draft Bill for introducing this system in the USA is 3½ pages long.
- It is very simple.

South Africa is a developing country and needs to simplify its laws and administration to enable its citizens to understand and cope with them. Citizens should be allowed to concentrate their minds on earning a living and not be forced to waste their time and hard-earned money dealing with time-consuming complexity.

1.2 Reducing the costs of compliance

Professor Hall and Dr Rabushka estimated the 1993 costs to American taxpayers:

Direct compliance costs (advice and completing returns)	$100 billion
Tax planning costs	$ 35 billion
Lost to fiscus through evasion	$100 billion
Loss through distortions and lost output	$100 billion
Cost to economy of lobbying activities	$ 50 billion
Estimated total cost	**$385 billion**
Total individual and corporate taxes	**$625 billion**
Estimated total cost as a percentage of taxes	**61.6%**

According to the authors increased economic efficiency, reduced compliance costs and lower tax rates would have a substantial positive effect on the US economy. South Africans would benefit even more from a simple flat tax system. The US economy can survive waste of such proportions but the South African economy cannot.

1.3 Reducing the incentive to make wasteful investments

In considering a new and additional tax such as CGT the Minister of Finance should take into account the cost to the economy of raising one additional rand of taxes as a result of the imposition of the tax. A US study has shown that the tax rates and types of taxes levied have little effect on the total tax collections as a percentage of GDP. However, they have a very substantial effect on total GDP.

Hall and Rabushka in *The Flat Tax* maintain that every one dollar of additional taxes levied in the USA has a disincentive effect equivalent to 30 percent of the estimated tax receipts from the new tax. However, as soon as a new tax is imposed, taxpayers change their behaviour in order to avoid paying the tax. Large amounts of money that would otherwise go towards increasing output in terms of labour supply, capital supply, and total output will be diverted. A substantial part of the productivity loss will consist of time and money spent on tax avoidance. The attention of entrepreneurs will be diverted away from productive enterprise to spending many hours with tax lawyers and accountants in order to devise tax avoidance schemes.

Capital gains tax on share investments will have an especially pernicious effect. Increases in the value of shares consist of a mixture of inflation and the current valuation of future income. Inflation increases should not be taxed, as they do not constitute a profit. Income earned is already taxed in the hands of a company and CGT on that portion of a share price increase will constitute double taxation.

As CGT is only levied on the sale of assets there will be less sales. This will mean that the capital in the economy will be placed in a straitjacket. Capital will no longer flow to where it is needed most - where it will make the greatest contribution to economic growth. The rigidity in capital flows will have a devastating effect on an economy that is starved for growth and employment creation. The prescription is clear: if you want less of anything, tax it. So, if you want less capital investment, or if you want capital investment in all the wrong places, tax it.

1.4 Reducing the incentive to evade taxes

Many newspaper columns have been filled in recent years with reports on tax evasion and how the Revenue Services are dealing with the issue. Yet the evidence shows that the best way to reduce tax evasion is to reduce the tax rates. Taxpayers who are risk-takers will evaluate the risk of being caught against the benefit gained from tax evasion. As tax rates are reduced, more and more people will choose to pay the taxes rather than risk being apprehended.

A culture of non-payment arises when taxpayers perceive the system to be "unfair". Lawyers and accountants who would otherwise advise their clients to pay their taxes become advisers, not only on methods of avoidance, but also on methods of evasion. Friends and colleagues of taxpayers comment with approval when hearing of instances of evasion. The moral fabric of society is then in decay. Tax evasion easily leads to fraud and other forms of criminal activity. Instead of hiring teams of expensive accountants to reduce evasion, government should replace the present complex system of taxation with a simple low flat tax system that reduces the incentive to evade tax.

1.5 Eliminating the necessity for taxpayers to employ tax experts and lobbyists

An estimated 500,000 lawyers, accountants and other professionals make a living out of helping taxpayers in the USA to comply with the requirements of their tax laws or reduce the taxes they have to pay. A conservative estimate is that the cost to the taxpayers is in the order of $35 billion (R260 billion). If the US adopted the Hall & Rabushka low flat tax system this expenditure would immediately fall away and the people involved in the tax industry could turn to doing productive work.

South Africa's tax system is not yet as complex as the US system but it is unfortunately moving in that direction. More and more people are turning to tax advisers. Adding a Capital Gains Tax will accelerate the process. Such a development should be avoided if at all possible, especially with thousands of new taxpayers entering the economy, many of whom have been historically disadvantaged. The new taxpayers will have great difficulty in dealing with the existing complex tax requirements without assistance. CGT will make matters worse. The tax system should be adapted to accommodate citizens, rather than have the citizens change or incur high costs to accommodate the tax system.

2. The Hall & Rabushka flat tax proposals

Professor Robert E Hall and Dr Alvin Rabushka are senior fellows at the Hoover Institution, Stanford University, USA. They first put forward their flat tax proposals for the USA in 1981 and published a second edition of their book *The Flat Tax* in 1995. The second edition includes refinements resulting from more than a decade of debate and critical scrutiny by economists and tax experts.

As stated above the authors propose an integrated flat tax that applies to both businesses and individuals but with separate tax forms for the two types of taxpayer. All businesses, whether owned by companies, close corporations, partnerships or individuals would complete the same tax form. The simplicity of the tax system can best be illustrated by reproducing the one page Individual Wage Tax and Business Tax forms (see attachments).

3. Why the Flat Tax system should be adopted in South Africa

The foregoing comments are based on an economic approach to taxation issue but tax equity is maintained by exempting the poor from income tax. In addition, the proposed simple low flat tax system will cater for specific current South African needs. It will:

- Be fair.
- Reduce the cost of compliance enormously.
- Eliminate double taxation.
- Improve incentives to invest.
- Make tax evasion more difficult and less lucrative.
- Increase economic growth.
- Encourage local investment by encouraging capital formation.
- Create new jobs by increasing real wages and improving incentives to work.
- Reduce interest rates immediately.
- Make taxpayers more honest.
- Attract foreign investment because the taxes will be simple, low and flat, and foreigners will not need to hire tax experts before investing.

4. An appeal to Members of Parliament

Objections to the Hall/Rabushka simple flat tax system can be expected from vested interests, including:

- Taxpayers currently receiving special privileges that reduce their taxes below the probable low flat rate this system will produce.
- Tax lawyers, accountants and other professionals that earn high incomes from the complexity of the existing system.
- Tax experts hired by the state to deal with the current complexity and to track down those who are evading tax or squeezing through the loopholes.

Government should not allow the vested interests to dissuade it from investigating the benefits of introducing the Hall/Rabushka tax system in South Africa. The authors should be invited to visit this country and explain their system to the Department of Finance and to the Members of Parliament.

A special appeal is consequently directed to the Department of Finance and the Portfolio Committee on Finance to examine the Hall/Rabushka proposals. Many eminent Americans, including members of both major parties have endorsed the proposed system. It has naturally been strenuously opposed by the vested interests, not least the 500,000 professionals who make a living out of the existing complex US system. This comment is not intended to be disparaging. It merely states the reality of the situation. Adoption of a simple flat tax system that taxes consumption rather than investment would transform South Africa. Hall and Rabushka estimate that if the flat tax were introduced in the US, there would be a 2 to 4 per cent increase in GDP on account of added capital formation within seven years. South Africa desperately needs added growth of such proportions.

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8 January 2001

ATTACHMENTS:

Form 1	**Individual Wage Tax**	**2000**
Your first name and initial (if joint return, also give spouses name and initial)	Last Name	Your social security no.
Present home address and postal code		Spouses social security no.
City, town, or post office, province, and postal code	Your occupation ➢ Spouse's occupation ➢	

1	Wages and salary ……………………………………..	**1**	…..……………………
2	Pension and retirement benefits ………….………...	**2**	……………………..
3	Total compensation *(line 1 plus line 2)* ……………….	**3**	……………………..
4	Personal allowance …………………………………….		
	(a) ☐ $16,000 for married filing jointly……………….	**4(a)**	……………….……
	(b) ☐ $9,500 for single………………………………...	**4(b)**	……………….……
	(c) ☐ $14,000 for single head of household …………	**4(c)**	……….……………
5	Number of dependants, not including spouse ………...	**5**	……….……………
6	Personal allowances for dependants *(line 5 multiplied by $4,500)* ……………………………………………	**6**	……………….……
7	Total personal allowances *(line 4 plus line 6)* ………...	**7**	……………….……
8	Taxable compensation *(line 3 less line 7, if positive; otherwise zero)* ………………………………………..	**8**	……………….…
9	Tax *(19% of line 8)* …………………………………...	**9**	……………….…
10	Tax withheld by employer …………………………….	**10**	……………….…
11	Tax due *(line 9 less line 10, if positive)* ………………	**11**	……………….…
12	Refund due *(line 10 less line 9 if positive)* ……………	**12**	……………………

Form 2	**Business Tax**		**1995**
Business Name			Employer identification No.
Street Address			Country
City, Province and Postal Code			Principal Product

1 Gross Revenue from sales ……………………..	**1**	________________
2 Allowable costs		
(a) Purchases of goods, services, and materials…………………………………….	**2(a)**	…………………………
(b) Wages, salaries, and pensions ……………..	**2(b)**	…………………………
(c) Purchases of capital equipment, structures, and land …………………………………….	**2(c)**	…………………………
3 Total allowable costs *(sum of lines 2(a), 2(b), 2(c)* ……………………………………………..	**3**	________________
4 Taxable income *(line 1 less line 3*) ……………..	**4**	________________
5 Tax *(19% of line* 4) ……………………………	**5**	________________
6 Carry-forward from 1999 ……………………..	**6**	…………………………
7 Interest on carry-forward *(6% of line 6* ………..	**7**	________________
8 Carry-forward into 2000 *(line 6 plus line 7)* …..	**8**	________________
9 Tax due *(line 5 less line 8, if positive)* …………	**9**	________________
10 Carry-forward to 2001 *(line 8 less line 5, if positive)* ……………………………………...	**10**	________________