

Capital Gains Tax:

The pros and cons

Olimpia Staszczuk

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Johannesburg: PO Box 785121, Sandton 2146, South Africa

Tel: (011) 884 0270 • Fax: (011) 884 5672 • Email: fmf@mweb.co.za

Cape Town: PO Box 10074, Caledon Square 7905, South Africa

Tel: (021) 465 1856 • Fax: (021) 465 1860 • Email: fmf.ct@mweb.co.za

Website: www.freemarketfoundation.com

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Foreword

The purpose of FMF *Monographs* is to use the analytic method of political economy to shed light on how best the promotion of free markets will improve the workings of the South African economy. In particular, authors are urged to apply the microeconomic approach of studying how individuals, firms and households behave in response to either naturally occurring environmental events or to institutional frameworks which have either evolved over time or been imposed by statute.

One of the most controversial changes to South Africa's tax system in recent years is the imposition of Capital Gains Tax (CGT) from 1 October 2001.

Simply, Capital Gains Tax is levied on the market value of an asset at realisation, less the cost of acquisition. Unlike most other taxes on income it is deferred, and is not levied on gains as they accrue year-by-year. Clearly in an inflationary environment, if the cost of acquisition is not adjusted upwards in real terms, then the tax ultimately paid is that much higher.

Thus if CGT is not inflation adjusted then there is a strong incentive for an investor to hold his asset rather than liquidate it. Similarly, the very presence of the tax provides an incentive for an investor to use discretion on the date of realisation. There is an inherent "lock-in" effect from the presence of CGT, exaggerated by inflation.

As a corollary the optimal portfolio behaviour is to realise losses immediately, and offset them against gains elsewhere.

In short, the presence of CGT distorts normal investment behaviour patterns. Participants in capital asset markets (primary or secondary, tangible or paper) are encouraged to behave in ways they would not in its absence. Resources are not then allocated to their highest valued uses (as consumers in the market place indicate) but rather towards uses which minimise tax liabilities.

So CGT distorts market efficiency. Or does it? After all, in its absence but in the presence of conventional income tax, there is also a distortion. Entrepreneurs and investors will then tend to direct their activities away from "income" generating activities (which are taxed) towards "capital" appreciating activities (which are tax free). This too is distorting. The fact that "income" and "capital" are arbitrarily defined by accountants and tax authorities merely underlines the fact that the presence *or* absence of CGT is distorting.

Conceptually a CGT could be constructed on an "accruals-equivalent" basis levied annually. The distortion effects from inflation, lock-in, and the absence of a CGT would then all be removed. In practice the administrative costs of putting such a system in place would be impracticably high at worst, or at best exceed the benefits of the tax-neutrality which such a system would aim at.

The author of this *Monograph*, a tax accountant, describes the controversies surrounding CGT in an informed and detailed manner. She suspects that the balance of advantage in South Africa is such that taxing capital gains penalises capital formation, a route we should not be taking at this stage in our history.

Indeed, she goes further, CGT she believes actually has negative implications for black economic empowerment

CGT is not a means of redistributing wealth from the rich to the poor. The wealthy can avoid the payment of the tax through well established techniques. The key to economic growth is entrepreneurship. CGT will hamper growth by creating a disincentive to entrepreneurs, and to the laying out of capital.

Entrepreneurs may or may not care about anyone else's economic well-being, but their investment benefits society nonetheless. It was not tax policy that built the United States of America into an industrial giant. America was made rich with capital investment and breakthrough advances in productivity. Higher living standards resulted. This is the reason why Capital Gains Tax should be avoided: to encourage and not impede capital formation – the mainspring of creating jobs, productivity and wealth for the nation as a whole.

The author writes that just as the fruit of a tree contains seeds for future trees so the fruits of success, capital gains, contain the seeds for future investment and success. Tax policies that punish success destroy the seeds that create and promise enterprise and jobs for the unemployed.

South Africa has a large divide between haves and have-nots. The author concludes that the introduction of CGT may be yet one more major lost opportunity for the previously disadvantaged to become owners and full participants in the broader economy.

As in all FMF publications, the views expressed are those of the author and are not necessarily shared by the members, directors or staff of the Foundation. Nevertheless this *Monograph* is recommended to all who are interested both in the narrower debate on CGT, and in the wider discussion about economic growth.

W Duncan Reekie

Bradlow Professor

School of Economic and Business Sciences

University of the Witwatersrand

Publications Editor, FMF

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The author

Olimpia Staszczuk completed her undergraduate and postgraduate studies at the University of the Witwatersrand. She recently completed her BCom Honours in Accounting majoring in Taxation. She is currently working in the Johannesburg office of PricewaterhouseCoopers.

1 Introduction

The objective of this *Monograph* is to evaluate the usefulness of a Capital Gains Tax (CGT) by examining the arguments for and against it. The study also includes an examination of the historic experience of CGT in the United States of America and Canada as well as the findings of economic studies on CGT. It is hoped that this will provide insight into the ability of the CGT to make the income tax system more equitable and credible, that it will dispel the myth that it is a tax that takes from the rich and gives to the poor, and that it will assist in determining the feasibility of the introduction of such a tax in South Africa now or in the future.

The Minister of Finance, in presenting his annual Budget in February 2000 announced the introduction of CGT with effect from 1 April 2001 and cited his main objective of giving the South African income tax system more equity and therefore making it more credible.

CGT is not a new concept. It has been widely used around the world and was introduced as early as 1913 in the United States of America. It has, however, been embroiled in controversy wherever it has been introduced. The consequences of the tax have always been hotly debated. Is CGT an equitable and efficient revenue producing taxation policy? What are its long-term effects on the economy and on the citizens whom it taxes?

2 What is capital?

Capital is the mainspring of an expanding society. The term conjures up images of money invested in the stock exchange or in a new business. But for the purposes of CGT, to think of capital as only a financial asset is incorrect. Capital is also the physical investment itself: the factory, the computer, the fax machine and other factors of production (other than labour) that make running a business efficient. A hawker's corner stand selling fruit couldn't survive without capital – the fruit and the cardboard stand make up the essential capital that allows the enterprise to operate.

Proponents of a South African CGT maintain that returns on capital accrue to the owners of the capital, and that the owners are wealthier than is the average South African. It is argued that the absence of a CGT benefits the most affluent. This argument, however, ignores the link between wage rates paid to workers and the amount of capital that they work with. Paul Samuelson, Nobel laureate and member of John F Kennedy's Council of Economic Advisers, said the following about capital formation:

“What happens to the wage rate when each person works with capital goods? Because each worker has more capital to work with, his or her marginal product (or productivity) rises. Therefore the competitive real wage rises as workers become worth more to capitalists and meet with spirited bidding up of the market wage rates.”¹

Capital is important because it embodies the tools (eg factories and equipment) that we work with. Greater capital formation means greater worker productivity and improvements in worker productivity lead to greater real wage rates and better working conditions.

¹ Moore S and Silvia J 'The ABC's of the Capital Gains Tax', 4 October 1995, *Policy Analysis*, No.242, pp.1-60.

3 What is a Capital Gains Tax?

CGT taxes the profit made on the sale of a capital asset. A capital gain arises when, on disposal (or deemed disposal), the consideration received is greater than the base cost of the asset. The base cost of the asset is the cost incurred in acquiring or enhancing a capital asset. Only expenditure of a capital nature and not of a revenue nature may be included in the base cost of an asset. The cost of acquisition includes any transfer duty or stamp duty paid as well as any VAT paid and not refunded. Legal fees, valuation costs and any commissions paid to agents are also regarded as capital expenditure.²

Strictly speaking, CGT targets the appreciation of wealth under an income tax regime and should not be regarded as a separate tax instrument. As a result, CGT is not a true wealth tax, but is the widening of the income tax base to include provision for the taxation of the appreciation or escalation of asset values.

A brief history of the Capital Gains Tax

To fully understand and appreciate CGT, a brief history of the tax in several countries should be examined.

In the United States of America CGT was introduced at the same time as personal income tax. This took place during the American Civil War. The taxes were needed to finance the war and were abolished once the emergency had ended. In the 20th century, the US government undertook a range of projects that needed financing through tax revenue. In 1913, to accommodate this need, the 16th Amendment to the Constitution of the United States was enacted to legalise personal income taxes as well as Capital Gains Taxes. Over the next eight years the legality of CGT was challenged successfully in the courts. The government, however, continued to collect the taxes and the Supreme Court ruled in 1921 that the tax was legal. Since that ruling, the rate at which tax is charged on the capital gain has increased when the budget is in deficit and has decreased when it is in surplus.³

In Britain, capital gains were not taxed when temporary personal income taxes were introduced in 1799, 1803 and 1842. These exclusions are believed to have been based on the view that the taxes were only temporary and that it was unfair to tax a one-time capital gain made during the period of the temporary tax regime.

In the 1960s the Labour Government brought CGT to Britain. The introduction was mainly aimed at financing its social security programs. However another important reason brought about the introduction of the tax. At that time, Britain's maximum personal income tax rate was around 90 percent. This high marginal tax rate provided an incentive for taxpayers to reinvest rather than to distribute profit at a higher rate than they would otherwise have done. Among other methods used to increase capital gains, employees also opted to receive lower salaries.

Tax avoidance manoeuvres such as those just mentioned in Britain, tend to cause economic inefficiencies. This is largely due to investment in projects within the firm that have a lower rate of return than other projects available in the economy. They also reduce the horizontal fairness of the tax system: owners of the business avoid paying taxes or reduce their liability below that which is payable by others who have an equal amount of other income in the form of wages, rent, interest and royalties.

Before the announcement of the introduction of CGT, South Africa had not levied tax on gains made on the sale of assets. The South African Revenue Service (SARS) had previously considered this form of taxation. In 1969 the Franzen Commission, now largely considered by the private sector to be discredited, proposed a limited form of CGT on immovable property and marketable securities. In 1986 the Margo Commission⁴ examined the case for the introduction of CGT in South Africa. At that time the Commission received overwhelming evidence that South Africa

² Guide to Capital Gains Tax (2000), Pretoria.

³ Grubel HG (2000) *Unlocking Canadian capital*, Fraser Institute, Vancouver, BC.

⁴ The Margo Commission Report of the inquiry into the tax structure of the Republic of South Africa (1987).

should not introduce CGT. This view was supported by, among others, the well-known tax advisor Michael Katz, the Johannesburg Stock Exchange, the Association of Law Societies and the Chamber of Mines. The main reason cited by the opponents of CGT was that its introduction would impair the formation of capital in South Africa at a stage in the economy when capital formation was essential. On the strength of this argument, evaluation of literature on the topic, and overseas experience, the Commission recommended, by majority vote, that it was against the introduction of CGT in South Africa.

The Katz Commission revisited the investigation into the introduction of CGT in 1995 and made the following recommendation:

“...by reason of the lack of capacity on the part of the tax administration, there should not be a Capital Gains Tax in South Africa at this stage. When the restructuring of the tax administration has been completed in line with the Commission’s recommendations in its first Report, the contentions for and against the possible introduction of this tax and its suitability for South Africa should be revisited...”⁵

In his February 2000 statement, the Minister of Finance indicated that he felt that the SARS was in a position to handle the complex additional administration that came with the introduction of such a tax. Michael Katz, chairman of the Commission of Inquiry into the tax structure of South Africa, apparently having had a change of heart, commented after the Minister’s announcement that CGT would make South Africa’s income tax system “more efficient and promote equity”. He said that it rendered many tax avoidance schemes, which turn taxable income into tax-free gains, less attractive.

⁵ Third Interim Report of the Commission of Inquiry into certain aspects of the tax structure of South Africa (1997).

4 The case for a Capital Gains Tax

Proponents of CGT have argued that it is equitable to tax a gain regardless of its source since a gain of any nature enhances the taxpayer's patrimony. The application of the 'ability to pay' canon should give rise to a tax liability. A fair tax system should be aimed at achieving both horizontal and vertical equity.

Horizontal equity

Horizontal equity ensures that people with the same income pay the same amount of tax. On the presentation of the 1965 United Kingdom Budget, James Callaghan had the following to say in this regard:

"The failure to tax capital gains is widely regarded ... as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage earner. It has in the past been one of the barriers to the progress of an effective incomes policy... Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains."⁶

Likewise, the 1966 Report of the Canadian Carter Commission, on whose recommendation Canada enacted its Capital Gains Tax laws, summed up its arguments in favour of this comprehensive income tax approach in the following way:

"Adoption of the comprehensive tax base requires the taxation of not only income from property, but also capital gains on the disposition of property. Almost everyone is familiar, at least in a general way, with the difference between income and capital, even though the words seem to be incapable of precise definition. Capital is the source of income. By levying a tax on income, the distinction between the two concepts takes on great significance, for if the courts find a particular gain to be capital the transaction is not now taxable. There is an enormous incentive for the taxpayer to try to transform income gains into (untaxable) capital gains (tax arbitrage). However, it is impossible to draw an unambiguous distinction between capital gains and income gains and the attempt to do so necessarily results in great uncertainty for the taxpayer because a particular transaction may or may not be found by the courts to fall on one side of the line or the other... After the most careful and exhaustive consideration of this complex question, we have arrived at the conclusion that the present distinction between kinds of gain is inconsistent with our concept of what we believe income is for the purposes of determining the individual's capacity to pay real tax... A dollar gained through the sale of a share, bond or piece of real property bestows exactly the same economic power as a dollar gained through employment or operating a business... To tax the gain on the disposal of the property more lightly than other kinds of gains or not at all would be grossly unfair... These radical reforms are advocated because (horizontal) equity can be achieved in no other way, because in our opinion there would be no adverse economic effects through their adoption when combined with our other proposed changes, and because they would simplify the tax system and reduce uncertainty."⁷

The concept of horizontal equity can be explained by a simple example: Consider Peter, who earns a R100 000 salary, and Betty, who earns a R70 000 salary plus, in one year, an additional R30 000

⁶ The Margo Commission Report. *Op cit.*

⁷ *Ibid.*

made through the sale of an appreciated asset. If income is taxed at 40 percent Peter will pay a tax of R40 000, while Betty, in the absence of a Capital Gains Tax, will pay R28 000. Yet both Peter and Betty earned a cash income of R100 000 before taxes. The concept of horizontal equity holds that Peter and Betty should be paying the same amount of tax. This objective can only be achieved if Betty's capital gain is taxed alongside her salary.

Vertical equity

Another argument in favour of CGT is vertical equity. Vertical equity requires that wealthier people should bear an absolute higher, and perhaps even a proportionately greater, tax burden. The latter would reduce inequalities in the distribution of wealth. Many people may consider the distribution of wealth in a country to be unacceptably unequal; a Capital Gains Tax or any wealth tax may be seen as an obvious way to reduce that perceived inequality. In a limited way, a Capital Gains Tax may be regarded as reducing inequality of wealth in much the same way as a progressive income tax system. Income and wealth are closely associated. In most cases wealth generates income and the larger the income the larger a person's scope for augmenting his wealth out of savings. A progressive income tax alongside a wealth tax mitigates inequality of wealth by reducing income inequalities and keeping in check the accumulation of wealth, since it is perceived that only those with high incomes can afford to save and make investments. But this interpretation is limited, particularly as it fits the view of many people who fail to distinguish between wealth and income. They apply the term 'wealthy' to people with large incomes and little property as well as to those with net assets of high value.

Other advantages

- If capital gains go untaxed or are taxed less heavily than other income, there is an incentive to switch from 'revenue' income to capital gains. CGT is an effective means of limiting this type of tax arbitrage.
- The failure to tax capital gains or the preferential treatment thereof erodes the income tax base, thereby contributing to the need for higher rates of tax on the restricted base. CGT can be used as a means of protecting the income tax base.
- Not taxing capital gains makes the income tax system less complex and comprehensive.
- Preferential treatment of capital gains undermines the contribution of the tax system to redistributive goals of government.
- Taxpayer morale and tax ethics may be improved through the introduction of a CGT. Lack of morale among some taxpayers may be attributed to their perception of the unfairness of the concentration of untaxable gains in the hands of the rich.
- Company shares are often the main source of capital gains, and retained corporate earnings are a contributing factor. If profits were taxed only when they were distributed, retained profits would escape normal tax and the corporate sector would retain most of its profits in the form of retained earnings. In a combined corporate and personal tax regime, the absence of CGT places a heavier burden on distributed earnings than on retained earnings.
- A fiscal advantage of CGT is that it generates data which can be cross-checked with other information collected by the revenue authorities to tighten up tax administration as a whole and enable evasion to be more readily uncovered. The information on capital gains would also help to build up a picture of ownership and the value of assets held.

5 The case against a Capital Gains Tax

The main arguments against CGT introduction can be grouped under two broad headings: Practical difficulties surrounding the tax and possible adverse economic consequences.

Practical problems of CGT

- Opponents of CGT say that its advantages are highly overstated in light of the practical realities of administering such a tax in the real world. The administrative difficulties mainly revolve around problems of disclosure and valuation. Some items are difficult for the revenue authorities to identify, often because they are omitted from the tax base or because they are grossly under-valued. The valuation of certain assets such as listed shares and other financial instruments does not pose a problem, but the valuation of land, private businesses and customised, one-of-a-kind assets, may prove to be very complex. Omissions from the tax base and discrepancies in valuation of the assets mean that the tax falls short in the attainment of horizontal equity and creates investment distortions often detrimental to the efficiency objective.
- Practical problems of administration are such that the costs are often very high and the results are often imperfect. The tax cannot avoid being highly complex and difficult to administer. It requires skills that could be better employed collecting taxes that are more productive of revenue. High costs are due to the following:
 - If the base is comprehensive, including assets other than just listed securities, an enormous number of assets have to be valued to determine the base cost and then to keep track of the costs of improvements.
 - Each transaction has to be assessed individually and not for each taxpayer as in normal tax.
- Self-assessment may reduce costs to the revenue authorities, but only if compliance costs, for the monitoring of such self-assessments, are raised.
- Simplifying procedures such as standard deductions at source are impractical in the case of CGT. These normally help to oil the wheels of the income tax system.
- If a taxpayer is required to submit his own valuations there may be a temptation to undervalue. If certain assets are difficult to identify, it follows that tax evasion by under-reporting is possible. In both cases the existence of CGT threatens standards of tax morality.
- In practice the tax has been found to yield a low return as a result of deferrals (rollovers) of the tax liability, offsetting gains against losses, and exemption of certain assets such as personal homes.
- The argument that the additional tax would supply the revenue authorities with data that can be cross-checked for evasion assumes that the perpetrators are either careless or simple-minded. Would-be evaders would certainly ensure that obvious inconsistencies could not be found between their investment income and their capital.
- Among the other problems of CGT is the pyramiding of gains in a group structure. For illustrative purposes, company A (a subsidiary of company B) makes a gain that is subject to 20 percent tax and then retains the balance. If B disposes of A, the price is likely to reflect the value of the retained 80 percent. This will attract a tax of $20 \text{ percent} \times 80 \text{ percent} = 16 \text{ percent}$ in the hands of B. The total amount of tax now paid is 36 percent. If B is the subsidiary of C and C is owned by D and so forth in a chain of subsidiaries, solving the scenario algebraically shows that the original gain is eventually exhausted by the tax. This double taxation can only be avoided by very

complex provisions. Long chains of subsidiaries tend to disappear from economies in which companies are taxed on their capital gains.⁸

- A gain realised in one year may be the result of the appreciation of an asset for numerous years, The full taxation of the capital gain would be excessive, resulting in the need for preferential treatment for assets held for long periods of time.
- It is important to note that complex taxes run by poor administrations tend to produce inequitable and often undesirable results.

Market distortions

- One of the most important arguments against CGT is that it reduces the incentive to save, since the tax base is accumulated savings. The tax discourages savings, and for as long as effort or enterprise has the objective of accumulation, it discourages work and enterprise too. President John F Kennedy said the following at the Congress on Tax Reduction and Reform in January 1963:

“The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital...the ease or difficulty experienced by new ventures in obtaining capital, and therefore the strength and potential for growth in the economy.”⁹

- CGT often creates a bias towards holding onto assets for extended periods of time. CGT is different from other forms of tax as it is in effect voluntary. Since the taxpayer is only liable for payment upon the sale of an asset, he can practically and legally avoid the obligation by postponing the sale. This phenomenon is known as the ‘lock-in effect’. This holding onto appreciated assets, that but for the tax would be sold, seriously retards and distorts markets. The only possible means of preventing this deferral would be to tax unrealised gains. But this contradicts the ‘ability to pay’ canon and is administratively impractical.
- CGT is aimed primarily at promoting equity. This purpose is seldom achieved in practice as it is the wealthy, at whom the tax is mainly directed, who are able to hold onto the assets for extended periods of time. Often they can time their realisations to coincide with capital losses usable to offset gains, thus effectively avoiding paying CGT altogether.
- Another argument related to the lock-in effect is that CGT aggravates fluctuations on the stock exchange. Behaviour of investors is highly sensitive to expectations regarding adjustments to CGT rates. An impending rate reduction would induce delays in share sales and large scale selling off of shares when the rate is reduced.¹⁰
- Rolling over of gains to create an ever-increasing deferral of tax liability would in the long term weaken the financial position of businesses as it creates an artificial need to remain invested.
- As it is often difficult to subject certain assets to CGT owing to practical problems of locating and valuing the assets, assets such as jewellery and artwork are often exempted from CGT. As a result there is often a bias to invest money into these non-productive assets.¹¹

⁸ There is evidence that such organisational forms can be beneficial. Kantor, B “Corporate restructuring and competition policy”, *Free Market Foundation Briefing Paper No.16*.

⁹ Grubel HG (2000) *Op cit*.

¹⁰ The lock-in phenomenon is discussed in more detail in a later section of this report.

¹¹ Ironside, DJ Sandford, CT and Willis JRM (1975) *An annual wealth tax*, Heinemann Educational Books Ltd, London.

- It would be socially unacceptable to tax the gains made on private housing so private residences are often exempted from the tax. This creates a tendency for residents to purchase larger and grander homes, which has been observed in both Europe and the United States of America.¹²
- Any tax on capital may induce internationally-mobile domestic capital to migrate to more favourable jurisdictions or dissuade foreign investment capital from investment in the local jurisdiction until the overall rate of return, after currency risk, has risen enough to offset CGT.

Other disadvantages

- To attract outside investment to overcome problems of jurisdiction it is often necessary to exempt gains made when foreigners sell local assets. This disadvantages local investors who own assets within the country and also creates shelter and an incentive for local residents to use approved structures to dispose of their local assets.
- The government employs many agents, accountants and lawyers to monitor and enforce the Tax Act. Likewise the private sector spends vast amounts of money to stay ahead of SARS. The authorities usually respond by investigating ways of closing loopholes. All such expenditure is an additional cost to society, financing unproductive activity to encourage wealth transfer rather than to promote wealth creation. CGT merely encourages further such unproductive spending and the proliferation of the wasteful ‘tax-advisory’ industry.
- CGT aims to promote vertical equity. According to Margo it has been the experience overseas that it is not the rich that pay the tax since they can hold onto their assets, but the poorer income-earner who is forced to realise assets to obtain cash.¹³
- Assets often appreciate in value largely because of inflation, and often it is merely as a result of inflation that nominal gains are made on the realisation of assets. So CGT is at risk of taxing largely illusory gains. Preserving a measure of equity requires indexing of gains for inflation, and this indexing can be very complex.¹⁴

¹² The Margo Commission. *Op cit.*

¹³ The Margo Commission para 12.35(c). *Op cit.*

¹⁴ The effects of inflation on capital gains are discussed in more detail under the section on tax fairness.

6 Macroeconomic effects of a Capital Gains Tax

The most significant argument in favour of CGT is its detrimental effect on the efficient allocation of resources. In the presence of high personal income tax rates, the absence of a Capital Gains Tax induces the owners to excessively reinvest profits. These profits end up bypassing more productive investment opportunities. No estimates of the size of the efficiency loss from the excessive reinvestment exist. The absence of estimates of these excessive reinvestments is unfortunate because the imposition of a tax which is designed to eliminate inefficiency has in other jurisdictions only caused further inefficiencies. As a result of the lack of data, it has been impossible to measure the cost-benefit of the introduction of the tax so it cannot be proven that it has benefited the economy by preventing excessive reinvestment.

The decision to introduce regulation must always be based on the economic costs of market failure as compared to government failure. The same concept should be applied to assess the merits of tax policies designed to correct problems caused by existing tax structures. One cannot argue that the economic cost of excessive reinvestment of profits by companies can be eradicated without additional costs arising from the introduction of CGT. The tax itself creates distortions, the costs of which have often exceeded the benefits.

Market efficiency

Assets are usually sold either because an alternative use such as retirement funding or the purchase of consumption goods is needed or because there are other profitable investment opportunities for the resources. In an economy where CGT is not levied, there would be a higher turnover of resources from investments yielding low returns to high-yield investments. Only the cost of obtaining information and the transaction costs of making the switch prevent the movement of funds between marginally different expected returns. In an efficient market it is essential that resources be invested in assets with the highest rate of return. Without this freedom of movement, the economy produces goods and services at lower profits than could be made through the creation of high-yield enterprises and products.

In terms of labour and unemployment, the freedom of movement of capital between old and new industries is also very important. In South Africa, resource-producing industries such as gold mining have been suffering as a result of declining world commodity prices, foreign competition and availability of substitute products. The South African government can do very little to remedy the situation and prevent many thousands of workers from being retrenched. A potential solution is sufficient finance at low cost. Capital used to fund new industries will provide new jobs. Only private investors can be relied upon effectively to find new opportunities with sufficiently high returns.

The lock-in phenomenon

Cash received from the realisation of an asset is reduced by CGT. Thus new investment projects must provide the investor with a high enough return to recoup the amount lost on the tax. The extra rate of return needed will depend on the size of the gain, the rate at which the gain will be taxed and the length of time that the asset is expected to be held.

The lock-in effect can be illustrated in the following example. An investment worth R1 000 with a return of 8,5 percent in perpetuity will carry a gain of R500 after five years. If it is realised then, under an assumed tax rate of 40 percent, a liability of R200 is incurred. Thus the investor has R800 left to invest in another project. Over five years the original investment at 8,5 percent per annum would have accumulated to R2 000 in the absence of any taxes. For an investment to grow to an equivalent R2 000 from an investment of R800 the return must be 13,4 percent. From this example it can be seen that for a taxpayer to finance a project with a time horizon of five years the project must at least yield a return of 13,4 percent. Projects yielding between 8,5 and 13,4 percent are therefore likely go unfinanced.

The lock-in effect is not unlike the excessive reinvestment of profits in an economy where capital gains are not taxable. This is because both of these cause market inefficiencies in the use of capital and create a gap between the most economically profitable use for the resources and the returns on the use of capital subject to tax. What is critical is the magnitude of the two relative to each other. While no solid empirical information is available, the following should be considered: Excessive reinvestment of profits is limited to capital used in industry because it is not possible to do so with other assets such as real estate or art. It is also limited by transaction costs and the desire of most owners of small and medium enterprises to retain control. This is not the case with the lock-in effect which involves not only productive capital but also other assets which do not allow for excessive reinvestment, such as loans, fixed interest securities and derivatives. The list could also include real estate, art and collectibles.

The brain drain and a tax on risk-taking

In a capitalist society entrepreneurs and risk-takers are the engines that drive a growing economy. They are responsible for the development of new products and services as well as the advancement of technology.

Entrepreneurs' work is risky by the very virtue of what it entails. New developments have to pass the market test and be sold at prices that make them attractive. For every Bill Gates who succeeds, tens of thousands fail.

Entrepreneurs often start with very little capital of their own. As their ideas begin to show some success or at least some prospect of success, investors provide the necessary financing for innovation to continue. Most of these investors have made their money on similar entrepreneurial successes.

As the venture becomes more successful, so profits begin to be made. These profits are reinvested to expand capacity and make more profits. Entrepreneurs and investors often receive very little income for extended periods of time. They sacrifice immediate gratification because the value of the company increases with each reinvestment. They only expect to be compensated for this sacrifice and their hard work once the company makes a public listing and offering on the stock exchange, or when they sell the company to a new buyer.

CGT reduces the return that such entrepreneurs and investors receive from their risk-taking, innovation and hard work. As a result the entrepreneur's incentive is reduced and the amount of money that investors are prepared to provide also falls. Would-be entrepreneurs may seek alternative career paths. The economy is harmed by this reduction in entrepreneurial activity. Business and job creation falls and possible improvements to living standards are left undiscovered.

Economic growth in countries with and without Capital Gains Tax

In a recent PricewaterhouseCoopers publication,¹⁵ the following comparison of countries with and without CGT and their corresponding annual average growth rate was documented:

¹⁵ PricewaterhouseCoopers, 'Worldwide summaries 1999-2000', November 2000.

Table 1: Capital Gains Tax and economic growth

- 1 Countries without Capital Gains Taxes: Hong Kong, Netherlands, New Zealand, Singapore and Switzerland.
Average annual growth in real per capital income 1990-97 = 2,2%.
- 2 Countries which indexed capital gains to inflation: Australia, Ireland, Luxembourg, Mexico and the United Kingdom.
Average annual growth in real per capital income 1990-97 = 2,3%.
- 3 Remaining members of the OECD that have Capital Gains Taxes: Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Italy, Japan, Korea, Norway, Poland, Spain, Sweden, Turkey.
Average annual growth in real per capital income 1990-97 = 1,2%.

It is interesting to compare Groups 1 and 2 to that of the remaining members of the OECD. The economic growth rates of the countries without CGT and those with CGT which indexes for inflation are nearly double that of the countries with a CGT system.

One indication of which nations will prosper economically in the future and which will not is the flow of international capital. As indicated in Table 1, many of South Africa's major competitors do not impose CGT on long-term capital gains or they allow for the indexing of the asset base. An abnormally high capital cost in South Africa will increasingly cause a barrier to growth in South Africa.

One should not place too much importance on this simple comparison since determinants of economic growth are far more complex, but the theoretical reasoning about the cost of the lock-in effect is supported in this data.

A tax favouring debt and not equity

An associated effect of CGT is that it encourages the financing of new business investment through debt and not equity. This is because corporate income is taxed when earned, then CGT is levied later on when taxpayers sell their shares in the firm. In contrast, income from debt-financed investments is taxed only once, because interest expenses are tax-deductible.

As a result a powerful and most certainly unintended consequence is the financing of corporate expansion and reorganisation through leveraging rather than equity.

The objectives of tax reform may be uniformity and equity, but what is the rationale of imposing a penalty on investors who are prepared to invest equity in a project in anticipation of future capital gains while providing a corresponding tax benefit for the use of debt financing? The result of this tax reform does not appear to be uniformity, nor does it favour capital. Instead it is a tilt against capital gains and in favour of debt!

The efficiency of taxes

All taxes induce people to adapt their behaviour to minimise the amount of tax that is payable. If taxes on capital are high, people prefer to consume their income rather than save or invest it. This consumption may involve short-term gratification such as overseas holidays or dining at restaurants or even the investment of resources into homes, art or recreational assets such as boats. These investments do not yield income that can be taxed and do not add to the measured national income or to the productivity of labour.

An interesting and important effect of CGT is the high investment in human capital that takes place. If a person becomes educated or receives training in a specialised area, an experience of an increase in income similar to a capital gain on a financial asset can be achieved. But the human gain is not subject to CGT, so an amount invested in education is taxed at lower rates than the equivalent amount invested in other assets. Because wages and salaries are taxed only once, overinvestment in

human capital becomes attractive. A similar investment in other assets may, however, be subject to double or even multiple taxation. Although investment in education cannot be faulted as such, capital absorbed in this way is not available to be used in other more productive ways in businesses, their research or innovation. The rate of return on human capital is generally much lower than that from other forms of capital. Hence productivity suffers and markets are once again distorted.

The effect on labour

Historically, when CGT rates are increased, job opportunities are reduced. The long-term impact on labour is not in the number of jobs, but in the wages earned.¹⁶

This concept is explained by the following chain of events:

- CGT lowers the expected after-tax return for the owner of the capital.
- The lower rate of return on capital causes businesses to reduce their capital purchases: Property, plant and equipment. So firms may use less capital and more labour to produce goods and services.
- Because capital is more expensive, the cost of production rises and output falls as a result.
- Workers have fewer capital goods to work with, so the average worker's productivity decreases.
- Wage rates are a function of productivity and, because workers' productivity has fallen, the wage rate will ultimately fall too.

¹⁶ Moore, S and Silvia, J. *Op cit.*

7 Tax fairness

Deductibility of the cost of the asset

Many countries tax capital gains because their systems allow the deductibility of consumer interest – interest paid on money borrowed to acquire assets that are not used in the production of income. With such interest being deductible against income, it follows that any gains made on the realisation of the assets should not escape the tax net. It is this factor that accounts for much of the CGT legislation in other jurisdictions, and not the equity concern. South Africa does not permit the deduction of interest on non-income producing assets. Under such circumstances, to tax the gains made on such assets would be considered inequitable, thereby creating greater rather than less inequality.

Capital gains and losses

In principle, capital losses should be deductible in full against either capital gains or ordinary income. The tax legislation however, does not always permit this, yet it taxes capital gains in full. This introduces a bias in the tax code against risk-taking. When taxpayers undertake risky ventures, the government taxes fully any gain they realise if the investment has had a positive return. But if it fails, as the majority of new ventures do, no recompense is to be had.

Capital gains and inflation

Capital gains cannot be treated on a par with current income flows when measuring income during a period of rising prices. An asset does not provide its owner with additional resources until the value of the asset exceeds its purchase price at prevailing prices at the time of sale. To measure income from appreciated assets, the portion of the capital gain that is a result of inflation should be deducted from the nominal capital gain. The calculation can be made by multiplying the purchase price of the asset by the ratio of a general price index such as the consumer price index on the date of sale to the value of the same index at the time that the asset was purchased. No such correction is necessary for current flows of income such as wages or interest received, because they give the recipient command over resources at the prices of the period in which they were earned. To index inflationary gains would have a dramatic effect on the distribution of taxable income and losses. Many apparent gains, which under a non-indexing system would be taxable, would now be converted into real losses. If no measures are taken to protect the taxpayer against inflation, the real tax burden of CGT increases and the tax bites into the taxpayer's capital. This is more serious than the effect of inflation in raising the burden of taxable income, because its effect is far more permanent. The taxation of inflationary capital gains violates the principle of horizontal equity.

The effects of inflation can be illustrated as follows: If George buys an asset for R1 000 and sells it for R1 200 after holding it for a period during which prices have risen by 50 percent then he would have made a nominal gain of R200, but a real loss of R300 at current prices!

Grubel (2000)¹⁷ cited Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve in Washington, as saying the following on the topic of taxation of inflationary gains:

“...it's really wrong to tax a part of a gain in assets attributable to a decline in the purchasing power of the currency, which is attributable to poor governmental economic policy. So, for government to tax peoples' assets which rise as a consequence of inferior actions on the part of government strikes me as most inappropriate.”

The taxing of inflationary gains is unfair as it erodes the purchasing power of savings and impoverishes pensioners and the aged whose savings get depleted. It is also counter-productive as it further intensifies the lock-in effect. Many investors choose to hold onto their assets, not only to avoid the payment of CGT, but also to avoid paying taxes on illusory gains or even actual capital losses.

¹⁷ Op cit.

Exemption of nominal gains from taxation requires that taxpayers document over what time they have held the asset and what the inflation rate has been. The appropriate rate of inflation would no doubt be a contentious issue. Should one use the consumer price index or another measure of the effects of inflation?

Double taxation

- An important inequity of CGT is that it is a double taxation on capital formation. Moore and Silvia (1995)¹⁸ quoted economists Victor Canto and Harvey Hirschorn as explaining the situation as follows:

“A government can choose to tax either the value of an asset or its yield, but it should not tax both. Capital gains are literally the appreciation in the value of an existing asset. The taxes implicit in the asset’s after-tax earnings are already fully reflected in the asset’s price or change in price. Any additional tax is strictly double taxation.”

An example of this could be shares held in a listed company. The value of the shares is based on the discounted present value of all the future proceeds of the company. If the company has a projected income of R100 000 per annum for the next ten years, the sales price of the shares will reflect these anticipated returns. The ‘gain’ that the seller realises from the sale of the shares will reflect these future returns and the seller will pay CGT on the future stream of income. But the enterprise’s future R100 000 annual return will also be taxed as it is earned. As a result the R100 000 profit is taxed twice – as the owner sells his shares and when the company actually makes the profits.

- The ownership of shares traded on stock exchanges is no longer limited to the privileged few, but in more recent times the ownership of large corporations has become increasingly widespread through the ownership of unit trusts and pension funds by many middle-income and lower-income earners. As a result CGT double-taxes not only the rich but also the ordinary man in the street who is attempting to save for his retirement.
- In order to attract capital, enterprises must earn for their investors a rate of return, including CGT, equal to that available in other forms to investors. If government imposes a tax on these returns, the enterprises resort to raising the prices on the goods and services that they offer. As a result, most of the tax is passed onto the consumers of goods and services, once again specifically the lower-income to middle-income earners who spend the largest portion of their incomes on the consumption of goods and services. The burden on these people is therefore increased rather than lightened as originally intended by CGT proponents.

Bracket creep

A serious consequence of a progressive CGT is what is known as ‘bracket creep’. Often elderly people who have lived prudently and reinvested most of their profits during their working lives will report a capital gain in the year of realisation. This singular event pushes them into a higher income tax bracket in that year.

The scenario would be the same for the estate of the deceased. On the death of the taxpayer, his accumulated gains would be deemed to be realised. In that particular year, the deceased would be recorded as having had an income much larger than in previous years.

These facts significantly impair the argument that CGT is an instrument for creating horizontal tax equity. It has precisely the opposite effect in practice.

¹⁸ *Op cit.*

8 Case study: The American and Canadian economies under a Capital Gains Tax

Since the introduction of CGT in the United States of America in 1913, controversy has surrounded the tax treatment of capital gains. Alan Greenspan the chairman of the US Federal Reserve Bank said the following in a Senate Budget Committee meeting in January 1997:

“Capital gains tax is not a revenue question. If we are interested in improving economic growth, the real question is how to encourage productivity-increasing investments.”¹⁹

In 1997 the appropriate rate at which the tax should be set, and the appropriateness of the tax as a whole, were controversial and hotly debated topics. It was in that year that the Taxpayer Relief Act reduced the top tax rate for long-term capital gains from 28% to 20%.

An evaluation of the revenue-raising function of CGT requires us to examine how much money the tax raises for government. In the USA the tax has been found to bring in surprisingly low amounts of revenue. In 1990 CGT revenue only amounted to between \$25 billion and \$30 billion a year. This represented just 6% of corporate and personal taxes and only 3% of total federal revenues. At that stage, if CGT were to have been abolished completely, the government would still have been able to collect 97 percent of its total tax revenue!

In 1992 in Canada the total tax collected by Revenue Canada for federal and provincial governments was approximately \$277,5 billion. Of this the CGT revenue was \$0,7 billion. Personal income taxes brought in \$103 billion. Therefore, CGT revenues were equal to 0,3 percent of the total and only 1,9 percent of personal income tax revenues!²⁰

The available information on these revenues suggests that they are insignificant in relation to other sources of revenue. Once again, reducing or even eliminating CGT would not have a drastic effect on the overall fiscal balance of either country.

Interestingly, there is strong empirical evidence from the USA supporting the hypothesis that lower rates cause revenue to increase rather than decrease. This is largely owing to three separate tax effects. The first is the unlocking effect which expands the tax base. We examined the phenomenon of the lock-in effect earlier in this *Monograph*. It is estimated that there is \$7,5 trillion of untaxed, unrealised capital gains in the USA. It is believed that over the last forty years the appreciation of capital assets has surpassed realised capital gains by nearly forty times! If the CGT rate were to decrease it is likely that some of these gains would be realised. The second is the dynamic effect. It measures the increase in tax revenue as a result of the impact of lower tax rates on economic growth. The last effect measures the increased revenue resulting from an increase in the value of assets. When CGT rates are lowered, the value of existing assets rises. Tax revenue rises as shareholders pay taxes on the higher value of realised assets. In addition the lower the tax rate, the lower is the incentive to avoid or evade tax – the cost and risk of evasion simply become too high.

Economists agree that for the American economy to continue growing, capital formation is of vital importance. One of the most important penalties on capital is the existence of CGT. America's unfavourable tax treatment of capital gains in the past has caused the slow down in the rate of growth. Between 1986 and 1992, fixed investment in business fell by 50 percent. At the same time investment in equipment fell by 33,3 percent. These low growth rates can be partly attributed to counterproductive tax policies that undermine long-term growth by discouraging savings and investment. Investment in capital is crucial to economic growth, firstly because it increases the amount of capital available in the economy and secondly because it enhances labour productivity. Unfortunately the level of investment in the USA compares unfavourably with other countries and

¹⁹ Hazelhurst, E ‘This soak-the-rich tax won’t work’, *Financial Mail*, 3 March 2000.

²⁰ Grubel HG. *Op cit*.

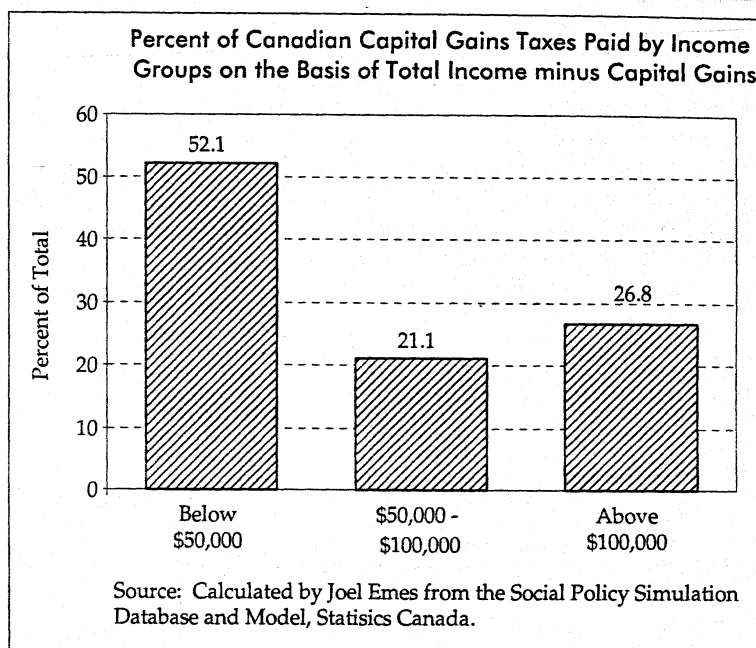
even with its own history. Net private domestic investment dropped from an average 7,4 percent of gross domestic product between 1960 and 1980 to only three percent from 1991 onwards.

The diminishing growth of investment can be attributed in part to the high cost of capital. Economist Yolanda Henderson with the Federal Reserve Bank of Boston²¹ estimated that approximately half of the rise in the corporate cost of capital is directly attributable to an increase in the CGT rate. The CGT rate in the USA exceeds that of many industrialised nations with the exception of the United Kingdom and Australia (and they index for inflation, which the USA does not). As a result, these countries experience higher long-term levels of saving, investment and productivity than the United States. In Singapore, where there is no CGT, the savings rate is approximately 50 percent. In the USA, with a CGT rate of 20 percent on long-term gains and 39,6 percent on short-term gains, the savings rate is only 16 percent. It is as Milton Friedman said: "If you want less of something, tax it". A lower rate of CGT would most likely help to improve the global competitiveness of the United States.

The view that CGT falls mainly on the rich should be reconsidered when examining the following data. For this purpose an attempt was made to measure the bias in the incidence of high income as a direct result of capital gains being realised in a particular year. Grubel (2000)²² selected Revenue Canada data of individuals who paid CGT in 1992, calculated income from other sources, and split them into income levels of less than \$50 000, \$100 000 or more, and those in between the two.

These data challenge the argument that CGT is an important means of taxing the rich and equalising incomes in Canada and in other countries. From the available data, more than half of CGT was paid by individuals with less than \$50 000 income per annum. As a result the middle class appear to bear the highest cost of the tax.

Likewise, in the United States, Americans with incomes of less than \$30 000 lodge 41,2 percent of all tax returns that contain capital gains, and pay 29,8 percent of all CGT. Those with incomes in excess of \$100 000 pay 45,5 percent of all CGT.



²¹ Moore, S and Silvia, J. *Op cit.*

²² *Op cit.*

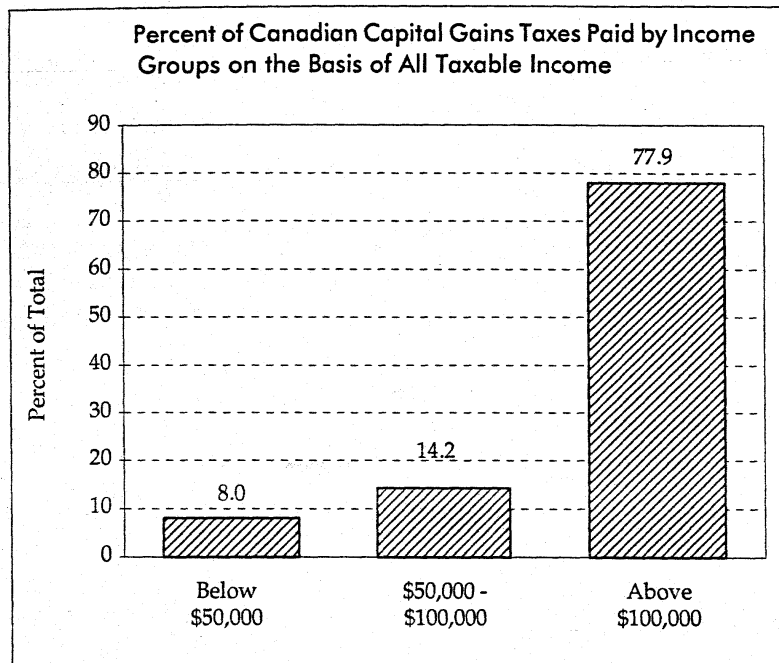


Table 2: Who pays Capital Gains Tax?

	Filers declaring capital gains (%)	Cumulative percentage	Share of capital gains tax paid (%)	Cumulative percentage
Under \$30 000	41,2	41,2	29,8	29,8
\$30 000-\$39 999	11,1	52,3	5,3	35,1
\$40 000-\$49 999	9,3	61,6	4,6	39,7
\$50 000-\$74 999	17,4	79,0	8,8	48,5
\$75 000-\$99 999	8,7	87,7	6,0	54,5
Over \$100 000	12,3	100,0	45,5	100,0

Figures are in US dollars

Grubel (2000) based these figures on the 1993 tax year.

The taxation of inflationary gains violates the principle of horizontal equity. Tracing the effective US CGT rates over the last few decades reveals the following: In 1975 the nominal rate was 38 percent and the effective rate was 40 percent. Thereafter the nominal rate steadily decreased to 20 percent, but because of high inflation, the effective rate rose to 110 percent in the 1980s. When inflation decreased because of credit tightening measures, the effective rate also fell. This is significant despite the fact that inflation has in the recent past been brought under control. This is because inflation will always abound and the war with it will always rage. Even if inflation per annum is low, cumulatively it could have an important impact. For example, an inflation rate of 1,5 percent per annum will result in prices 45 percent higher in just 25 years. The implication is that for investments to maintain their real value they too have to increase by at least 45 percent!

9 Should South Africa introduce Capital Gains Tax?

Economic growth

The objective of tax reform should be the attainment of the highest possible economic growth and the most rapid improvement in the welfare of all people within a country. In announcing CGT, the Minister of Finance cited the reasons for its introduction as bringing equity to the tax system and also bringing South Africa in line with the rest of the world that already has CGT.

The introduction of CGT in South Africa promises to make tax legislation even more complex and incomprehensible to the average South African taxpayer. As it is, lawyers and tax advisors already spend a large amount of unproductive time striving to minimise the effects of tax. It is suggested that CGT will only heighten this effort to continue spending vast amounts of money in order to avoid paying tax to the revenue authorities.

Over the last few years South Africa has witnessed a decline in the level of tax morality, hastened particularly because taxpayers see little in return for their tax money. The introduction of new taxes will only serve to further heighten the problem of lack of tax morality.

Despite the fact that the proposed South African tax system is not as complex as the US system, it is inevitably headed in that direction. Thousands of previously disadvantaged citizens are entering into our economy as new taxpayers. It is anticipated that these novice taxpayers will have difficulty in dealing with the current tax system and its complex requirements without the assistance of costly tax advisers. CGT will only make matters worse and advisers more expensive. It should be the aim of the fiscus to accommodate the citizens of its country rather than to make them change or expend large amounts of time, money and effort to adapt to the tax system.

Anthony Chait, senior partner at Fisher Hoffman Sithole, said the following about life in South Africa:

“Living in South Africa is stressful enough and a punitive wealth tax may be the proverbial straw that breaks the taxpayer’s back.”²³

Emigration as a result of crime, and the existence of exchange controls, have been major causes of the flight of capital from South Africa. CGT may be another factor that will discourage people from retaining their capital within South Africa. In a country starved of capital this could be seriously detrimental to economic growth and stability.

A heavy tax, ostensibly aimed at the wealthy, could lead to further flight of skills and capital. In South Africa this appears to be self-defeating. The most advantageous way of assisting the poor would be to set rates of tax that encourage investment of wealth so that jobs can be created and the economy can expand to benefit all. A developing country should not aim to have the same tax rates and complexities of taxation as developed countries; instead it should strive to become more attractive to investors in terms of the fiscal policies that it implements. Low rates of tax encourage citizens to save. In South Africa only 14 percent of the gross domestic product is currently being invested. This impacts directly on already very low levels of growth.

The compliance costs of such a tax are expected to be high. Estimates are that it will cost R40 million to introduce the new tax, including the printing of tax forms and the establishment of help/service centres. It will then cost approximately R100 million per annum to administer. Government has conceded that it expects to make a loss in the initial years after the introduction of the tax, but hopes that it will eventually start to bring in revenue. Michael Katz has admitted that the tax is not aimed at raising large amounts of revenue. He said that the tax must be looked at holistically and in terms of rounding off the income tax system. SARS claims that it is capable of handling the additional administration that comes with such an introduction, but one must not underestimate the costs of training and reassigning staff and inefficiencies during the phasing-in period.

²³ Mulholland S ‘Spectre of crippling wealth tax is laid to rest-for now’, *Business Times*, 11 December 1996.

Tax equity

One of the main cited reasons for introducing CGT is to promote tax equity. The flaws of this argument have already been discussed. The people who are most likely to be penalised under the tax are the productive, hard-working and thrifty citizens of South Africa who need to provide for their retirement if they are not to burden their families or the state. The current government relies heavily on the votes of the poor and previously disadvantaged. The equity argument appears cosmetically attractive in promising to tax the rich and equalise the playing fields. But what the poor have not been told is that they will be better off without the tax than with it.

Anti-avoidance

CGT also aims to render avoidance schemes that convert income into capital gains less attractive in the long run. But for as long as there is a rate differential at which revenue income and capital gains are taxed, the incentive remains. The proposed rates are effectively lower than individual and even corporate income tax rates. Thus the incentive remains to convert income into capital gains subject to a lower rate of tax. It seems that the objective of rendering avoidance schemes unappealing cannot be achieved by the proposed system.

Unemployment is an inevitable reality of South African life. Governments cannot create jobs directly, but what they should strive to promote are taxation and fiscal policies that will provide incentives to work, promote entrepreneurship and eliminate the brain drain. The economic effects of CGT are such that all three are negatively affected. For these reasons CGT is not a feasible policy to implement, particularly while our economy is in such a fragile state.

Estate Agencies are already anticipating the distortions that the tax will have on the property market. John Herbst, AIDA National Franchises CEO, believes that the introduction will have long-term effects on investments in property. In the short term it is likely that people will change the way in which they conduct their affairs in order to avoid the new tax. This is likely to result in increased property transactions initially, but once the tax comes into effect it is expected that there will be a slowdown. The tax will affect not primary one-home property owners but speculators and investors, who want as much return as possible, and who will invest in safer, more lucrative options if they have to pay heavy taxes on the sale of property. In South Africa, where the property market has suffered a slump in recent years, further distortions in the way that the market transacts are not desirable.

In the past, the majority of South African citizens were prevented by harsh and unjust legislation from accumulating capital. This new legislation, although in a completely different guise, also prevents capital accumulation and savings. This is clearly not in the best interests of a country that has made equality of ability to accumulate capital its primary objective. CGT clearly stands in direct conflict with the government's RDP and GEAR programmes which are primarily aimed at restoring equity in a country where equity did not exist in the past.

South Africa's monetary authorities are directly responsible for inflation. Inflation decreases the ability to purchase and erodes savings. It impoverishes pensioners and the elderly. Their life savings diminish through no fault of their own. Inflation itself can be seen as a tax on savings. To further tax inflationary gains only adds to the inequity of the tax.

South Africa is a country with enormous potential for development. We are a nation rich in natural resources. Our tax system should be one that aims to maximise our talents and resources and to promote investment, savings and growth. What this entails is a system that:

- is fair;
- reduces the cost of compliance;
- eliminates double taxation;
- improves incentives to invest;
- renders evasion unattractive and difficult to achieve;
- stimulates economic growth;

- encourages local investment through capital formation;
- creates employment opportunities;
- increases real wages and improves incentives to work;
- improves tax morality;
- attracts foreign investment.

This *Monograph* suggests that all these objectives will be hampered through the introduction of CGT.

10 Conclusion

CGT is not a means of redistributing wealth from the rich to the poor. The wealthy can avoid paying the tax by using well-known and internationally well-established techniques. The key to economic growth is the upward-striving middle class and CGT will hamper this growth by creating a disincentive to save and invest.

The rich may or may not care about anyone else's economic well-being, but their investment benefits society nonetheless. It was not tax policy that built the United States of America into the industrial giant of the 20th century. The Capital Gains Tax did not exist until World War I and it was not burdensome until World War II. America was made rich with capital investment and breakthrough advances in productivity which drove living standards up. This is the reason why Capital Gains Tax should be avoided: to encourage and not impede capital formation – the mainspring of creating jobs, productivity and wealth for the nation as a whole.²⁴

Just as the fruit of a tree contains the seeds for future trees, so too the fruits of success, capital gains, contain the seeds for future investment and success. Tax policies that punish success ultimately destroy the seeds that create and promise enterprise and jobs for the unemployed.

South Africa has a rapidly growing divide between haves and have-nots. The avoidance of the introduction of CGT may be the last major opportunity for the previously disadvantaged to become owners and full participants in the broader economy.

²⁴ The IMF, an organisation much in the pocket of the world's developed economies, is not in favour of South Africa being an attractive alternative investment destination, thereby drawing funds away from its sponsoring nations. For this reason, its recommendation that South Africa should introduce Capital Gains Tax as a matter of urgency, should be viewed with great scepticism.

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