

*Capital gains
taxation and its
applicability
to South Africa*

*by
Roger Baxter*

FMF Occasional Paper No. 12

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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

FMF *Occasional Papers* are designed to make available to a wider audience essays on current matters of pith and moment.

This *Paper*, originally presented to a Parliamentary Portfolio Committee charged with discussing the introduction of Capital Gains Tax (CGT) in South Africa, more than meets that criterion. It is written by an economist with a deep practical understanding of how capital investment is linked with economic growth. Not only does capital investment stimulate growth, but taxation of capital gains discourages investment. Roger Baxter, who has worked as a senior economist in both the mining and investment banking industries, demonstrates this by drawing on basic economic concepts and examining the international evidence.

What is CGT? 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, if the cost of acquisition is not adjusted upwards in real terms in an inflationary environment, then the tax ultimately paid is much higher.

Thus if CGT is not inflation-adjusted there is a strong incentive for investors to hold their assets rather than liquidate them. Similarly, the presence of CGT encourages investors to rely on legally induced rather than economically motivated discretion on deciding the date of realisation. As Baxter points out (p.10) there is an inherent 'lock-in' effect from CGT, exaggerated by inflation.

It follows that optimal portfolio behaviour would be 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 the absence of CGT. Resources are not then allocated to their highest valued uses (as reflected by consumer preferences in the market place) but rather towards uses which minimise tax liabilities.

So CGT does distort market efficiency. But what is the alternative? After all, in its absence, in the presence of a 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 eliminated. In practice the administrative costs of putting such a system in place are impracticably high at worst, or at best would exceed the benefits of any move towards tax neutrality which such a system would aim at.

But Baxter goes further. CGT in and of itself is both vertically (p.13) and horizontally inequitable (p.15). Further, in an economy where the encouragement of small business is seen as a driving force for both equality and economic growth, CGT would be counter-productive (p.10) by inhibiting the small-scale type of enterprise in which black entrepreneurs would flourish.

CGT is no means of redistributing wealth from the rich to the poor. The wealthy can avoid it through well-established techniques. The key to economic empowerment is entrepreneurship. CGT provides entirely the wrong incentives to entrepreneurs and for the investment of capital.

The author points out in Chapter 4 that this increasingly understood in other countries. Elsewhere CGT either does not exist, or where it does rates are being reduced.

South Africa has a large divide between haves and have-nots. The introduction of CGT is yet one more barrier which the historically disadvantaged sectors of society will now have to overcome as they strive to become owners and full participants in the wider 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 *Paper* is recommend-

ed to all who are interested both in the narrower debate on CGT and in the wider discussion about the linkages between capital investment and growth.

W Duncan Reekie

Publications Editor, FMF

Bradlow Professor of Industrial Economics

University of the Witwatersrand

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The author

Roger Baxter is the Chief Economist of the Chamber of Mines of South Africa. After completing graduate studies in economics from the University of Natal in 1990, Mr Baxter joined the Chamber and became involved in a number of mining and macroeconomic issues. In 1995 he was appointed as Senior Economist and by 1998 became the youngest ever Chamber of Mines Economics Advisor. In October 2000 he was appointed the Chamber's Chief Economist.

Roger Baxter has served on a wide range of committees and structures both within the Chamber and externally. He is an active member of Business South Africa's (BSA's) Economic Policy Committee and is a principal member of the NEDLAC Trade and Industry Chamber. He was involved as a principal member of the BSA negotiating teams in NEDLAC for the *Skills Development Bill*, the *Energy Policy White Paper* and led the BSA input on the *Nuclear Regulatory Bills* and the *Minerals Development Bill*. He also was part of the BSA competition policy task team. He is currently co-Chairing the BSA team negotiating a new industrial strategy in NEDLAC. He has played roles in a number of other BSA projects and is currently leading a project on the impact of administered prices. He was a member of the State President's Adjudication Committee for Export Achievement awards for four years. He has played a role in the South African Chapter of the International Chamber of Commerce (on the Executive Committee) and was previously a director on the board of Rand Refinery. He is a member of the Investment Analysts Society of South Africa and is Chairman of the Finance Committee of the Economic Society.

1 Introduction

The South African government has based its introduction of capital gains tax (CGT) on two principles:

- To promote equity at both the vertical and horizontal levels. To prevent sophisticated taxpayers converting otherwise taxable income into tax-free capital gains – thus eroding both the corporate and individual income tax bases.
- To conform with international taxation practice (i.e. to bring South Africa’s “tax dispensation in line with the systems of our major trading partners”).

In the South African Revenue Service (SARS) guide¹, notable quotes from both the Carter Commission’s recommendations in 1966 and the United Kingdom experience in 1965 are cited which point to the unfairness to wage-earners as a result of certain taxpayers converting taxable income to tax-free capital gains. A number of Commissions in South Africa also investigated the concept of CGT and its applicability to South Africa. The more recent Katz Commission² supported the concept of a CGT on the following grounds:

- To limit the tax arbitrage between capital gains and normal gains.
- Tax equity, where the maxim of horizontal equity dictates that people with equal economic power should bear equal tax burdens, while vertical equity requires that wealthier people should bear progressively higher tax burdens.

Based on the purported benefits of CGT – as espoused by the Katz Commission – the major obstacle at that stage was believed to be the lack of capacity within the SARS to implement and collect the CGT. Katz recommended that when the capacity problem at SARS was solved the CGT issue should be revisited.

The Parliamentary Joint Standing Committee on Finance³ (JSCOF) believed that the Katz Commission report did not deal conclusively with the question of the CGT, thus perpetuating uncertainty. The JSCOF⁴, “aware of the reluctance at a recent conference of the Commonwealth Association of Tax Administrators to advocate a capital gains tax in countries that had not already instituted them,” recommended that:

- The present weakness of Inland Revenue to administer this or any other tax should not form the basis of an in-principle decision whether or not to impose such a tax...
- The substantive arguments for or against imposing such a tax should be the determining factors.

Guided by the recommendations of the JSCOF that the substantive arguments for and against the tax should be the deciding basis for the introduction of such a tax, I argue that the principle of introducing a CGT should be tested against the following questions:

- Should the fundamental premise of taxation policy be based on “taxation equity issues” or on savings, investment, capital accumulation and, ultimately, economic growth?
- Does CGT actually promote equity and who really bears the costs of CGT?
- What are the global trends with respect to CGT?

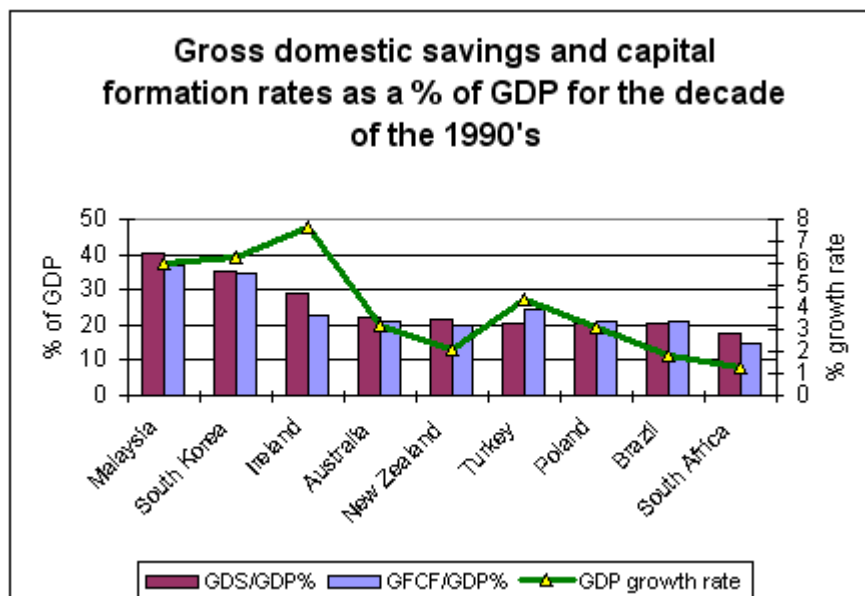
2 *What is the fundamental premise of taxation policy: Equity or economic growth?*

Savings and capital formation are vital for economic growth

In answering this question it is rather important to place South Africa in the context of the global emerging-markets universe with respect to domestic saving, fixed investment and economic growth. This is not to say that savings are the direct determinant of fixed investment and economic growth. There are other important risk and sentiment issues that affect investment hurdle rates and thus investment. However, the accumulation of capital (human, physical and natural) is inextricably linked to economic growth and development. In particular, the accumulation of physical capital is an absolutely vital component of economic growth. According to a study by Dale Jorgenson of Harvard University⁵, the increase in US capital formation (gross fixed capital formation) was responsible for nearly half of the growth of the US economy between 1948 and 1980.

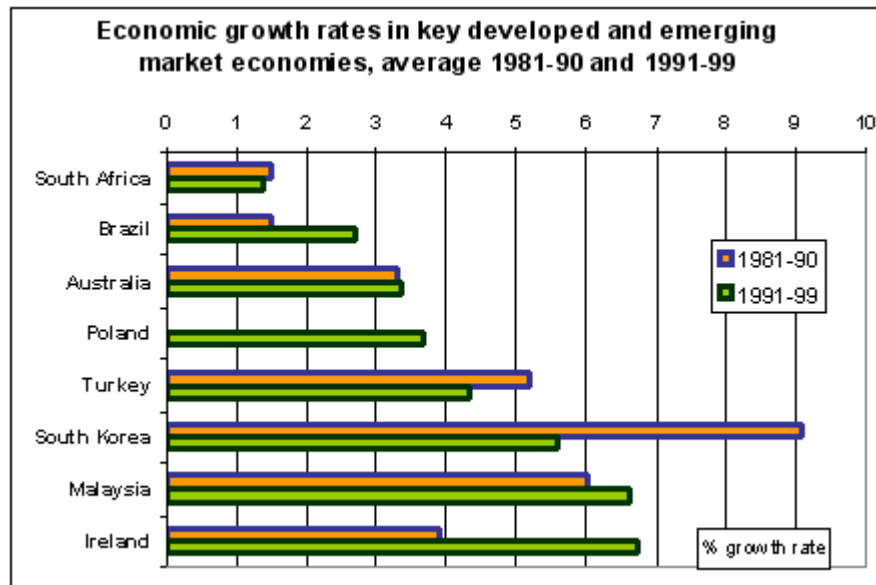
According to John Page⁶, “accumulation of productive assets is the foundation of economic growth”. The emerging market economies that have experienced high economic growth rates have accumulated both physical and human capital much more rapidly and consistently than other economies – and that accumulation accounts for a large portion of their superior performance. What is interesting is that the high-performance, emerging market economies have all had high domestic savings rates to fund high levels of fixed investment, which in turn led to high levels of physical capital accumulation. In fact, no emerging market economy has been able to sustain economic growth rates higher than 5 percent per annum without having fixed investment rates (gross fixed capital formation to GDP ratios) of at least 25 percent of GDP. In a closed economy a 25 percent investment ratio would require a minimum savings level of 25 percent of GDP. In an open economy foreign savings can top up savings shortfalls but this is normally limited to about 2 percent of GDP. So in order to fund higher fixed investment levels countries have to have higher levels of domestic savings.

South Africa’s domestic savings and fixed investment rates are the lowest out of 29 emerging market countries surveyed. Selected emerging market and developed country examples are included in the following graph:



Source: World Bank database

It is interesting to note that countries with high investment rates are also the best performers in terms of economic growth as shown in the following graph:

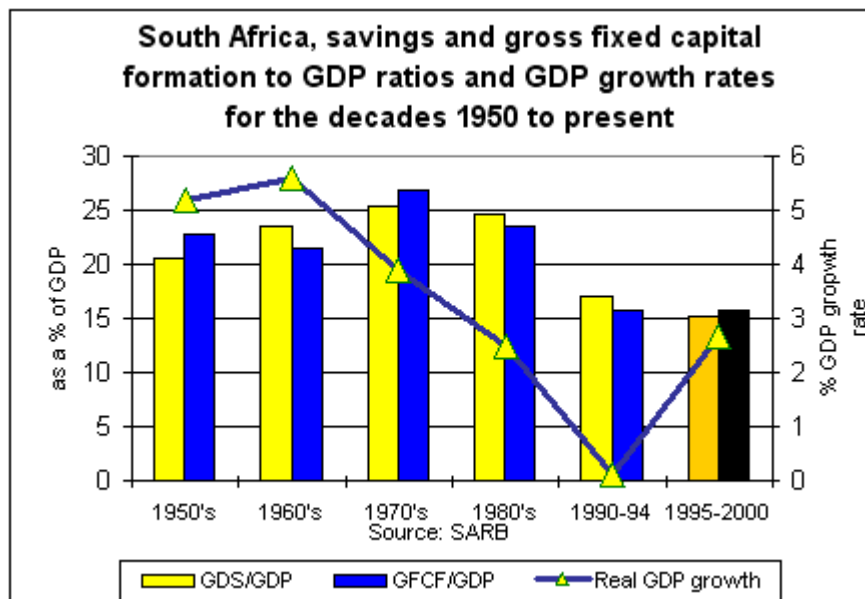


Source: World Bank database

Unfortunately, South Africa’s low investment rates have confined the country to the lowest growth quartile within the emerging markets universe. The trends in domestic savings, investment and economic growth for South Africa are shown on the following page:

There is no doubt that the pursuance of sound macroeconomic policies in the new democratic era has placed the economy on a sounder, higher-growth footing. However, the low levels of domestic savings and investment simply cannot provide for physical capital-accumulation levels which would result in a growth rate beyond 4 percent per annum. The government is increasingly placing priority on promoting economic growth to raise living standards. President Mbeki⁷, at the launch of the Millennium Labour Council, stated the following:

A critical question, which needs to be addressed, is the matter of massively expanding productive investment by South Africans in our economy. Despite accelerated economic growth after 1994; the growth in Gross Domestic Fixed Investment has been slow. As South Africans we must find ways of saving more and investing more so as to generate more wealth and create more jobs.



Source: Chamber of Mines and SARB

Economic growth, sustainable employment creation and rising living standards are absolutely crucial for South Africa's social and political future. Government policies that undermine this objective need to be seriously reconsidered.

Tax equity – positive concept, but insignificant compared to the economic growth issue

Tax equity is driven by concepts such as “fairness,” “progressivity of the tax burden,” and so on. As mentioned in section one, in the Katz Commission's⁸ view on equity issues the concepts are certainly meritorious. There is certainly little benefit in objecting to the issues of tax equity. However, it has become clear (section three of this report will deal with where the burden of CGT falls) that CGT is not the correct policy instrument to use to achieve tax equity. Evidence from research on the issue suggests that the real burden of CGT fall on those who aspire to wealth, not on those who have it.

The government has suggested that the arbitrage between tax-free capital and taxable income undermines the tax base. It is perhaps worthwhile to question the extent of this problem.⁹ It appears as if the government has not considered the negative impact of CGT on economic growth and thus normal tax receipts. Studies¹⁰ indicate that CGT actually undermines growth and thus the tax base.

Research points to CGT undermining savings, capital formation, growth and development

There is a growing body of research that concludes that CGT undermines savings, capital formation, economic growth, employment opportunities, productivity and the potential output of any economy. In the United States several studies have shown that reducing CGT would cause greater levels of economic activity. A 1995 study by Allen Sinai¹¹ concluded that the proposed US CGT cut would boost national savings, increase capital spending, raise real GDP growth, increase employment, reduce the cost of capital and improve household net worth. Dr Sinai again validated this position with further research in 1997.¹²

What the following table illustrates is that a lower CGT in the USA would lower the cost of capital, thus increasing business capital spending by \$17.6 billion per year. Higher levels of capital formation and fixed investment would add an additional \$51 billion to GDP annually and the result of higher levels of economic activity would generate close to half a million new jobs per year.

The McGraw-Hill/DRI study¹³ found similar benefits from lower CGT in the US. In 1999 a study by David Wyss.¹²

Found that the improvement in the economy over time (based on the 1997 CGT reduction) is significant. Our model suggests that after 12 years, GDP would be 0.4% higher than in the baseline, adding \$116 billion to incomes.” He went further: “the model probably understates the impact of capital gains”.

Table 1: Estimates of the Effects of a Capital Gains Tax reduction* on the USA, average per year, 1997-2002

Indicator	Impact of CGT cut, per annum	Quantum
Real GDP	Extra amount (in 1992 money)	\$51 billion
	Extra annual growth rate	0.1%
Business capital spending	Extra amount (in 1992 money)	\$17.6 billion
Hourly compensation	Percentage point change	0.1
National savings	Extra amount (in 1992 money)	\$44.1 billion
Federal tax receipts	Extra amount (in 1992 money)	\$17.2 billion
Employment	Extra jobs created	356 000
Unemployment rate	Percentage point change	-0.2
Productivity growth	Percentage change	0.1
Household net worth	Percentage change	2.1
Cost of capital	Pre-tax equity, percentage change	-6.

Source: Allen Sinai Testimony before the Senate Finance Committee, March 13, 1997.

*50% exclusion of personal capital gains and 25% tax rate for corporates.

Even a paper by Steven Fazzari¹⁵ who was sceptical about the benefits of CGT reductions indicates that the output benefit of a CGT reduction would be of the order of 0.3 percent per annum. If this rate is compounded over five years the benefits become significant.

Many respected economists maintain that having no CGT at all would be optimal for economic growth. They argue that completely eliminating the tax – i.e. a CGT of zero percent – would be fair and most efficient for the economy because the CGT imposes a multiple (at least double) tax on savings and investment. By punishing such productive activity CGT stifles capital formation, an essential force behind economic expansion. For example Kenneth Judd¹⁶ of Stanford University has maintained that the optimal tax rate on capital gains is less than, not greater than, zero.

The US Federal Reserve Board Chairperson, Alan Greenspan, has consistently supported abolishing the CGT. In his 1997 testimony before the Senate Banking Committee, Greenspan¹⁷ elaborated on his previous testimony before the Senate Budget Committee:

The point I made at the Budget Committee...was that if capital gains tax were eliminated, that we would presumably, over time, see increased economic growth which would raise revenues for the personal and corporate taxes as well as other taxes we have.... The crucial issue about capital gains tax is not its revenue-raising capacity. I think it is a very poor tax for that purpose. Indeed its major impact...is to impede entrepreneurial activity and capital formation... While all taxes impede economic growth to one extent or another, the capital gains tax is at the far end of the scale. I argued that the appropriate capital gains tax was zero.

Other economists¹⁸ have supported Greenspan’s view and many concluded that the greatest contribution to long-term economic growth in the US would arise from eliminating the CGT.

By removing the destructive bias against savings and investment, totally abolishing the capital gains tax would unleash the economy's powerful, natural forces.¹⁹

One overarching conclusion of the effects of CGT reductions in the USA, Canada, Australia and the UK is that the benefits flow to all workers and the economy as a whole. Workers benefit from greater appreciation in their pensions, unemployment is reduced and the average worker will see wage gains associated with the greater investment in higher productivity activities.

The support by many distinguished economists in many developed economies for a zero capital gains tax, and the empirical evidence of the negative effect of CGT on savings, investment, economic growth and job opportunities, provide food for thought regarding CGT applicability to South Africa.

CGT has a deleterious effect on venture capital and small business

Small businesses (SMMEs) and entrepreneurship are the driving forces behind any market economy. SMMEs are affected by the strength of incentives that motivates business people to undertake innovative projects and their ability to raise enough capital for such projects. Venture capital is an important source of funding for SMMEs, but the impact of CGT lowers the potential return from backing financiers (many of whom are private individuals) thus reducing the quantum of venture capital available.

For entrepreneurs wanting to start SMMEs one of the key motivations is the potential capital gain that will arise if the project is successful. Many entrepreneurs will spend a lifetime sacrificing current income and leisure to ensure that their SMME survives and can be sold. For any SMME owner (under 55 years of age) wanting to sell his/her business the capital gain will be taxable, pushing the owner into a higher (once-off) tax bracket without inflation indexation. If potential returns are taxed, the entrepreneur's motivation is reduced!

As far back as 1963 the late President John F Kennedy²⁰ said:

The present tax treatment of capital gains and losses is both inequitable and a barrier to economic growth....The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital from static to more dynamic situations, the ease or difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential growth of the economy.

The impact of CGT on economic efficiency (and the lock-in effect)

Mr. Grote,²¹ Chief Director of Tax Policy in the National Treasury, argues that the lack of CGT results in individuals investing their savings in assets that provide capital returns (such as property) rather than investing in productive assets (plant and machinery). The argument is that the lack of a CGT undermines investment efficiency. Unfortunately this argument relies on the model of a closed economy where domestic savings fund domestic fixed investment. In a more globalised open economy like South Africa's, investment decisions are made on the basis of risk-return trade-offs in a global sense. The lack of investment in productive capacity in the economy is not because the absence of CGT is encouraging investment in property – it is due to the cost and risk profile of South Africa being too high and the domestic supply of savings being too low. The introduction of CGT will not automatically shift investment from property into productive assets.

The economic-efficiency rationale for introducing CGT is further undermined when one considers the private compliance costs borne by the taxpayer and the economy. A study by Bracewell-Milnes²² of the US economy concluded that CGT imposed an "excess burden" on small business to the tune of nine times its tax revenue yield. This means that small businesses have to spend \$9000 to comply with the law (to hire valuers, accountants, upgrade computer systems, etc) for the government to realise \$1000 in CGT revenue. The opportunity cost of the lost working hours comply-

ing with CGT, especially if this time had been spent productively on wealth-generating activities, is significant. CGT therefore does not promote economic efficiency.

The compliance costs for government to administer CGT also undermine the economic-efficiency argument. Due to the high cost and low yield of CGT it appears that such government effort could be better spent capturing taxes where the yields are more significant (e.g. debts owed by VAT vendors) and the costs lower. From a perspective of government investment and economic efficiency regarding the use of public funds it would be more appropriate to concentrate on the latter and not on CGT.

CGT interferes with the dynamic, efficient reallocation of capital in an economy by forcing people, especially those with small returns on their assets, to defer realising a capital gain, which locks capital up in assets, some of which may be unproductive. While the government has provided certain rollover provisions in the draft legislation, it must be borne in mind that the CGT then has a significant bearing on how investors make decisions. It is probably better for an investment to be made on the basis of good underlying economic fundamentals rather than on the basis of tax reasons (i.e. to prevent lock-in or to realise a gain).

The overriding premise for tax policy should be economic growth

The principles of tax equity are meritorious, but the real issue is whether tax equity is more important than encouraging higher levels of savings, investment, capital formation and economic growth and ultimately raising living standards for all our people. Mines believe that the issue of economic growth is paramount for South Africa's future success. The introduction of CGT will undermine this objective. The government, in introducing CGT, is doing so on the basis of a flawed premise.

3 Does CGT actually promote taxation equity and who really bears the costs of CGT?

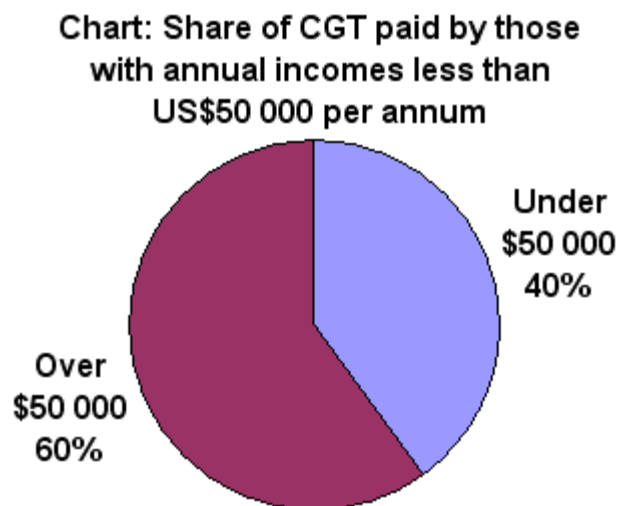
The majority of people who pay CGT are middle-to-low-income earners

Research emanating from the United States²³ and Canada²⁴ has refuted the long-held belief that capital gains taxes are an important instrument for taxing the wealthy and promoting tax equity. In both the USA and Canada roughly 50 percent of the burden of capital gains tax falls squarely on middle-and-low-income families. In the US 54.5 percent of the CGT burden is paid by people earning less than \$100 000 per annum. People with annual incomes of less than \$50 000 per annum accounted for 40 percent of CGT paid.

In Canada it is estimated that over half of all capital gains were paid by families with incomes of less than \$50 000 per annum. One of the significant reasons for this is that the majority of middle and lower income earners realise a once-off capital gain which pushes them into a higher tax bracket for that year (the “bunching effect”).

Vertical equity and CGT

The vertical-taxation equity principle holds that, on the basis of rising incomes, those earning higher incomes can afford to pay a progressively higher tax burden. The fact that the majority of the burden of CGT falls on middle-to-low-income households as described in section 3.1 has significant ramifications for the vertical equity issue.



Source: Heritage Foundation calculations

The following quotes are appropriate in this regard:

The simple fact is that anyone sitting on a big pot of money probably isn't paying capital gains taxes.... And the Government can adopt rule after rule – but the people who get stuck paying capital gains taxes will be ordinary investors” (David Bradford,²⁵ economist at Princeton University).

How fair is a tax that the wealthy can apparently avoid but the middle class gets stuck with? I don't see any fairness in that" (William Gale²⁶ of the Brookings Institution).

Capital is mobile and difficult to tax – it flows away from places with strict constraints and high taxes to locations where it can freely circulate and grow. This is why CGT revenues are low: the tax burden effectively falls on the most immobile factors. Thus the popular claim that CGT is a tax on the rich is misleading. The tax is effectively paid by those who cannot move their capital or themselves. Is this fair? (Reuven Brenner²⁷).

Horizontal equity and CGT

The horizontal-taxation equity principle holds that people earning the same income, whether by capital gain or by wages, should be taxed at the same rate in a given year. Because of the “bunching effect”, whereby capital gains are realised in a bunched up fashion and do not occur on a regular basis, individual taxpayers are pushed into a once-off higher tax bracket – so the income from capital gains is not strictly the same as that of income gains.

While it may be true that income from a capital gain accrues the same purchasing power as an equivalent sum of wage income, it is worthwhile considering the equity concept over a period longer than one year. Capital gains are normally earned by owners of small businesses who sacrifice leisure and current income to make their business succeed and thus reward them with a once-off capital gain. If the capital gain had been taxed at a rate of accrual in the years it was building up, it is likely that the total tax paid by the small business would be lower than a once-off capital gain. The material difference between capital and wage income does violate the horizontal equity principle.

The taxation of inflation gains hurts low capital growth earners the most

Perhaps the most inequitable characteristic of the proposed CGT for South Africa is that the proposal forces people to pay taxes on inflation. Taxing inflation dramatically increases real effective tax rates especially for people with low rates of return on their investments. The following table illustrates that a company with a small nominal rate of capital gain over five years pays a much higher capital gains tax on real returns than companies with higher returns.

Table 2: Effective Capital Gains Tax rates for various nominal rates of return, given 5% annual inflation

Annual nominal rate of capital return (%)	Nominal value of asset held 5-years (rand)	Nominal capital gain(rand)	Tax liability @ 50% of 30% of nominal capital gain (rand)	Real capital gain (rand)	Effective tax rate on real capital gain (%)
6	13382	3382	507.3	619	81.9%
8	14693	4693	704	1930	36.4%
15	20114	10114	1517	7351	20.6%
25	30518	20518	3078	17755	17.3

All calculations are based on a R10000 initial investment held for five years with an average annual inflation rate of 5%.

Source: Author

The lack of indexation for inflation imposes a severe penalty on companies with small capital returns. According to Federal Reserve Chairperson Greenspan:²⁸

...it's really wrong to tax a part of a gain in assets which are attributable to the decline in the purchasing power of a currency, which is attributable to poor government economic policy.

4 *Global trends regarding capital gains taxation*

Application of CGT varies widely

One of government’s tenets for the introduction of the CGT is that South Africa will then be in line with international practice. The purpose of this section is to highlight that the application of CGT varies widely between countries and that it is not a universal practice. The application of the practices of exemptions and exclusions, indexation for inflation and minimum holding periods, varies considerably from country to country. For example, in the case of individual capital gains the first \$8 315 is exempt in France while in Germany all capital gains are excluded from CGT if the asset is held for more than six months.

The following table attempts to capture, for one class of potential capital gain (equities), what the practice is regarding CGT in various countries.

In the table below eight countries do not levy CGT on personal equity capital gains. Several countries – Argentina, Belgium, Hong Kong, Malaysia, the Netherlands, New Zealand and Singapore, for example do not tax personal capital gains at all.

Table 3: International comparisons of CGT rates for individuals

	GDS / GDP %	Maximum individual tax rate	Individual capital gains maximum short-term CGT rate on shares	Individual capital gain maximum long-term CGT rate on shares	Individual holding period
Argentina	18.0	33.0	Exempt	Exempt	No
Australia	21.0	48.5	24.5	24.5 + indexation	No
Belgium	23.0	56.7	Exempt	Exempt	No
Brazil	18.0	27.5	15.0	15.0	No
Canada	21.0	31.3	32.0	32.0	No
Chile	26.0	45.0	45.0 annual exclusion \$6600	45.0 annual exclusion \$6600	No
China	44.0	45.0	20.0 shares traded on major exchange exempt	20.0 shares traded on major exchange exempt	No
Denmark	21.0	61.7	40.0	40.0 share values <\$16000 held 3-years exempt	Yes, 3-years
France	21.0	58.1	26.0 annual exclusion \$8315	26.0 annual exclusion \$8315	No
Germany	21.0	48.5	55.9	Exempt	Yes, 6-months
Hong Kong	23.0	20.0	Exempt	Exempt	No
India	31.0	30.0	30.0	20.0	Yes, 1-year
Indonesia	24.0	30.0	0.1	0.1	No
Ireland			20.0	20.0	No
Italy	33.0	46.0	12.5	12.5	No
Japan	22.0	50.0	1.25% of sales price or 20% of net gain	1.25% of sales price or 20% of net gain	No
Korea	30.0	40.0	20.0 Shares traded on major exchanges exempt	20.0 Shares traded on major exchanges exempt	No
Mexico	34.0	35.0	Exempt	Exempt	No
Netherlands	23.0	60.0	Exempt	Exempt	No
Poland	26.0	40.0	Exempt	Exempt	No
Singapore	18.0	28.0	Exempt	Exempt	No
Sweden	50.0	57.0	30.0	30.0	No
Taiwan	22.0	40.0	Exempt (local company shares)	Exempt (local company shares)	No
UK	N/a	40.0	40.0 Shares valued at less than \$11225 exempt	40.0 Shares valued at less than \$11225 exempt	Yes, 1 to 10-years
USA	16.0	39.6	39.6	20.0	Yes, 1-year
Average	25.5	42.1	18.5	15.4	80% have no holding period

Source: study by Arthur Anderson LLP for the American Council for Capital Formation Centre for Policy Research.

At the corporate level a similar picture emerges with a significant number of countries exempting corporate equity capital gains from CGT.

Table 4: International comparisons of CGT rates for corporates

	GDS / GDP %	Maximum corporate tax rate	Corporate capital gains maximum short-term CGT rate on shares	Corporate capital gain maximum long-term CGT rate on shares	Corporate holding period
Argentina	18.0	33.0	33.0	33.0	No
Australia*	21.0	34.0	34.0	34.0	No
Belgium	23.0	40.2	Exempt	Exempt	No
Brazil	18.0	33.0	33.0	33.0	No
Canada	21.0	29.1	38.0	38.0	No
Chile	26.0	15.0	15.0	15.0 asset cost is indexed	No
China	44.0	33.0	33.0 shares traded on major exchange exempt	33.0 shares traded on major exchange exempt	No
Denmark	21.0	34.0	34.0	Exempt (3-year holding period)	Yes, 3-years
France	21.0	41.7	41.7	23.8	Yes, 2-years
Germany	21.0	25.0	45.0	45.0	No
Hong Kong	23.0	16.0	Exempt	Exempt	No
India	31.0	35.0	35.0	20.0	Yes, 1-year
Indonesia	24.0	30.0	0.1	0.1	No
Ireland			20.0	20.0	No
Italy	33.0	37.0	37.0	27.0 (after 3-year holding period)	Yes 3-years
Japan	22.0	34.5	34.5	34.5	No
Korea	30.0	28.0	20.0 Shares traded on major exchanges exempt	20.0 Shares traded on major exchanges exempt	No
Mexico	34.0	34.0	34.0	34.0	No
Netherlands	23.0	35.0	Exempt	Exempt	No
Poland	26.0	32.0	Exempt	Exempt	No
Singapore	18.0	26.0	Exempt	Exempt	No
Sweden	50.0	28.0	28.0	28.0	No
Taiwan	22.0	25.0	Exempt (local company shares)	Exempt (local company shares)	No
UK	N/a	30.0	30.0	30.0 asset cost is indexed	No
USA	16.0	35.0	35.0	35.0	No
Average	25.5	31.0	23.2	20.1	84% have no holding period

Source: study by Arthur Anderson LLP for the American Council for Capital Formation Centre for Policy Research.

*Australia: CGT is being reduced to zero for overseas pension fund venture capital investors from the USA, UK, Japan, Germany, France and Canada.

There have been significant reductions in CGT in a number of countries

In a number of jurisdictions (USA, Australia, Canada and UK) there have been significant reductions in the rate of CGT and in a number of countries there have been calls for a total elimination of CGT because of its distortionary effect on savings, investment and economic growth. According to Allen Sinai,²⁹ “the trend is towards a lower, and in some cases a zero, CGT in most countries around the world.” The following table highlights countries that have reduced and modified CGT:

Table 5: Examples of countries that have reformed CGT policy

Country	Comment
Australia	In 1999, the Federal Government Business Tax Review (the Ralph Commission) proposed that the maximum CGT rate on individuals be dropped to 30% with a \$1000 tax-free exemption. CGT on long held assets should be reduced to zero to encourage investment. The "New Tax System" came into force on 21 September 1999. CGT only applies to 50% of gains made by an individual and trust, while small business can get up to 100% exemption in a number of cases. Indexation and averaging were abolished to reduce the complexity and compliance costs of CGT. The rate of CGT applicable to corporates will be reduced with the decline in the company tax rate to 30%. Funds from venture capital investors from a number of developed countries were exempted from CGT.
Canada	In 2000 the Standing Senate Committee on Banking, Trade and Commerce in a report on CGT recommended that CGT rates be significantly reduced to promote international competitiveness.
Germany	The German Bundestag adopted the Tax Reform 2000 on 6 July 2000 with substantial corporate and income tax relief granted (max corporate rate reduced to 25%). Capital gains from the sale of shareholdings between corporations will be exempt from CGT with a 1-year holding period requirement.
UK	In 1999 the UK reduced CGT rates for investments lasting more than 3-years to 22% from 40%. For 5-year investments the CGT rate was reduced to 10%. To boost employee share ownership, shares held by employees for more than 5-years will be exempt from CGT and income tax.
USA	In 1997 US CGT was lowered to 20% from 28% for holding periods of greater than one year. In 1999 the US House of Representatives approved US\$792 billion in tax cuts including reducing the top CGT rate on investment profits for individuals to 15% from 20%. CGT rate for low-income earners reduced to 7.5% from 10%. Certain motions have been made for a total abolition of CGT.

This table does not capture all recent CGT changes world-wide but attempts to show that international practice is moving towards lower CGT rates and ultimately to abolishing the tax in a number of countries.

Many countries have not introduced CGT

The governments of New Zealand, Malaysia and Holland decided not to introduce CGT because the compliance costs (not only for government but also for businesses) were too high and revenues were too low. In Argentina, Belgium, Hong Kong and Singapore personal capital gains are not taxed at all.

5 Conclusion

Even if the government's fundamental premise of taxation policy was that of tax equity, CGT will not achieve this end. If the government's central objective of taxation policy is to facilitate economic growth and development then CGT is detrimental to this objective. Instead CGT will undermine savings, investment, capital formation and economic growth and ultimately it will undermine employment levels and living standards. South Africa's major global trading partners and competitors have either not introduced the CGT at all or, where they have, the CGT rate has been lowered or is currently under review. As the old saying goes: If you want less of something – tax it. Do we really want a lower rate of capital growth in South Africa?

Footnotes

- 1 SARS *Guide to Capital Gains Tax*, 23 February 2000, p.4.
- 2 Report of the Katz Commission into Tax Reform (Third Interim Report), Chapter 6, Capital Gains Tax.
- 3 *Final Draft Report of the Joint Standing Committee on Finance on the Third Interim Report of the Katz Commission of Enquiry into Taxation*, Chapter 8, On Capital Gains Taxes.
- 4 *Ibid.*
- 5 Jorgenson, Dale (1995) *Post-war US Economic Growth*, Vol.1 of Productivity (Cambridge, Mass: MIT Press).
- 6 *The East Asian Miracle, Economic Growth and Public Policy*, Oxford University Press, p.191.
- 7 President Mbeki, Address at the Launch of the Millennium Labour Council, 7 July, Midrand.
- 8 Katz. *Op.cit.*
- 9 Under the current tax laws capital gains from shares and property (with exceptions) are already taxed as normal taxable income (unless kept for more than 5-years).
- 10 For example, US Joint Economic Committee Staff Report, “Cutting Capital Tax Rates: The Right Policy for the 21st Century”, August 1999.
- 11 Allen Sinai, Chief Economist Lehman Brothers, Testimony before the House Ways and Means Committee, 24 January 1995.
- 12 Allen Sinai, Chief Economist Primark Decision Economics, Testimony to the Senate Finance Committee, 13 March 1997.
- 13 DRI/McGraw-Hill, *The capital gains tax cut, its investment stimulus, and revenue feedbacks*, April 1997.
- 14 David Wyss, Chief Economist DRI, “Capital gains taxes and the economy: A retrospective look”, June 1999, p.3.
- 15 Steven Fazzari and Benjamin Herzon, “Capital gains tax cuts, investment and growth”, Jerome Levy Economics Institute Working Paper No. 147, October 1995.
- 16 Kenneth Judd, “The optimal tax rate for capital income is negative”, NBER Working Paper 6004, April 1997.
- 17 Alan Greenspan, Testimony before the Senate Banking Committee, 25 February 1997.
- 18 For example, Gary and Aldona Robbins, “Putting capital back to work in America,” Institute for Policy Innovation Working Paper, no.134, May 1994.
- 19 *Ibid.*
- 20 President JF Kennedy, Special Message to the Congress on Tax Reduction and Reform, 24 January, 1963.
- 21 Grote, M and Fletcher, K “Capital gains tax in South Africa”, *South African Journal of Economics*, Vol.68: 4 2000, p.789.
- 22 Bracewell-Miles, B “CGT: Reform through abolition”, in *A discredited tax: The CGT problem and its solutions*, IEA, 1992, pp.65-85.
- 23 The Heritage Foundation calculations, based on IRS data.
- 24 The Fraser Institute, “Unlocking Canadian capital – a critique of the equity issue”, Herbert Grubel, Senior Fellow, “The case for Capital Gains Tax reform”, May 2000.
- 25 David Bradford, CBO, Perspectives on the ownership of capital assets and the realisation of capital gains.
- 26 *Ibid.*

- 27 Reuven Brenner, Evidence to the Standing Senate Committee on Banking, Trade and Commerce, “The taxation of capital gains”, Canada, May 2000.
- 28 Alan Greenspan, *Op. Cit.*
- 29 Allen Sinai, Evidence to the Canadian Standing Senate Committee on Banking, Trade and Commerce, Fifth Report, “The taxation of capital gains”, May 2000.