

**A CRITICAL
ASSESSMENT OF THE
CAPITAL GAINS TAX AS
A FISCAL POLICY TOOL
FOR SOUTH AFRICA**

Author: Matthew Marcus
MRCMAT001

*A technical report submitted in partial
fulfilment of the requirements for the degree of
Master of Commerce (Taxation) in the
Department of Accounting
University of Cape Town*

February 2006

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ACKNOWLEDGEMENTS

The author of this study wishes to gratefully acknowledge the following:

- Amanda Fitschen, for her time, input and supervision
- Barry Ger, for his review and assistance

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ABSTRACT

This dissertation attempts to critically analyse the tax on capital gains as an addition to South Africa's fiscal framework. The method of the analysis involves the collation of international research on the effects of capital gains tax on the economies, financial markets, labour markets and revenue authorities of various countries. The focus is on the economic and fiscal areas directly relating to the long-term economic and fiscal policy goals of the South African government. These goals, as well as the justification given by the South African Department of Finance and the South African Revenue Service for the introduction of the capital gains tax are presented in the literature review section of this study.

Research of international tax practices indicates that the taxing of capital gains has a depressive effect on capital formation, labour productivity, foreign and domestic direct investment, business creation, entrepreneurship and taxpayer equity. In addition, the introduction of such a tax has no proven growth effects on governmental revenue, and does not significantly dissuade tax avoidance schemes using arbitrage measures.

By applying the globally observed effects of the capital gains tax to the long-term policy goals mentioned above, I conclude that the capital gains tax does not assist in the achievement of the economic and fiscal policy goals of the South African government, neither in the short- nor the long-term. Conversely, the capital gains tax acts as a countermeasure to the achievement of the said goals.

TABLE OF CONTENTS

List of Tables and Figures	iii
1 Introduction	1
1.1 Purpose of the Study	1
1.2 The Definition of Capital	4
1.3 The Definition of Capital Gains	6
1.4 Arguments For and Against the Taxing of Capital Gains	7
2 The South African Capital Gains Tax	8
2.1 Reasons for Introduction	8
2.2 General Provisions of the South African Capital Gains Tax	11
3 Critical Framework of the Study	15
3.1 The functions of government and fiscal policy	15
3.1.1 Allocation	15
3.1.2 Redistribution	15
3.1.3 Stabilisation	16
3.2 Historical South African Fiscal Policy Goals	18
4 International Evidence of the Effects of a Capital Gains Tax	20
4.1 Global Competitiveness, Economic Growth and Capital Formation	20
4.2 Employment	30
4.3 Savings and Investment	31
4.4 Revenue Effects	34
4.5 Wealth Creation and the Taxation of Illusory Income	36
4.6 Small Business Creation	39
4.7 Effect on Anti-avoidance	41
4.8 The Promotion of Taxpayer Equity	46
5 Application of the International Observations to South African Fiscal Policy Goals.	50
5.1 Introduction	50
5.1.1 Sustained Economic Growth	50
5.1.2 Increased Productive Employment	52
5.1.3 Increased Competition and Enterprise Development	54
5.1.4 Increased Productive Investment with Associated Capital Formation	55
5.1.5 To Combat Avoidance Schemes that Eroded the Efficiency of the Tax Base	59
5.1.6 To Improve the Overall Equity of the South African Tax System	61
5.1.7 Redistribution of Resources to Increase Overall Equity	63
6 Conclusion	65
7 Bibliography	71

LIST OF TABLES AND FIGURES

Table 1: Comparative capital gains tax rates of selected countries..... 51

Figure 1: Composition of South African venture capital investors 57

1 INTRODUCTION

1.1 Purpose of the Study

The objective of this dissertation is to identify the quantitative and qualitative international research and experience on the economic and fiscal effects of a tax on capital gains, and to utilise this research to critically evaluate the South African capital gains tax as an effective fiscal policy tool. The study will include the empirical results of existing global studies, and will examine similar indicators in a domestic context.

Based on the existing literature, it is clear that a tax on capital gains has been alternatively supported and decried by various economic and financial specialists.

Globally observed effects of such a tax allows for the creation of a critical framework against which the effectiveness of the South African capital gains tax can be measured.

A country's fiscal policy should, in terms of general economic theory, reflect the economic and fiscal policy goals of the government. This concept is especially relevant for a developing economy such as South Africa, which has suffered from slow economic growth, high levels of inflation and unemployment and a skewed distribution of wealth and resources across its population due to the long-term effects of Apartheid. It would be improper for the government of South Africa to introduce a fiscal tool which has globally observed effects that are counterproductive to alleviating the abovementioned economic malaise.

The research and critical framework is compared to the long-term economic and fiscal policy goals of the South African government. The results of the comparison will allow us to conclude whether the newest fiscal tool introduced in South Africa is congruent with its policy goals, and whether it is an effective method of aiding in the achievement of these goals.

This study has been performed subject to certain limitations. As economic and financial indicators are influenced by a variety of factors, it is extremely difficult to isolate the effect of a single one of those factors (i.e. capital gains tax). This study cannot measure the effect of capital gains tax on the South African economy.

The recent introduction of capital gains tax imposed limitations on this study that were not present in the global studies that were reviewed. The studies performed in Europe, the United States, Canada and Asia were, for the most part, conducted on tax systems that had included capital gains tax for an extended period of time. The international researchers also often had the opportunity of measuring the effect of key events pertaining to the tax, such as changes in legislation, increases or decreases in the effective tax rates and in certain cases its complete removal from the relevant jurisdiction. The absence of such events in the short-term South African context imposed limitations on the direct comparison of the domestic and global cases.

Finally, although not a significant limitation for the purposes of this study, the overall differences in the systems of capital gains tax used in the various countries reviewed internationally limited the ability of this study to provide direct comparisons between the noted effects thereof. However, the broad analysis was not affected, as the

differences pertain to specific asset classes and holding periods, and did not significantly preclude the possibility of comparison in a general, country-wide scope. Furthermore, the international researchers largely compared the effects of changes in the rates of tax on capital gains, and not situations where the tax was not present in a country's legislation with the exception of the Hong Kong study.

1.2 The Definition of Capital

The term “capital” is defined and understood differently for the purposes of finance, accounting and economics. In finance, capital is commonly understood as the initial amount contributed by an investor to a given investment. In accounting, capital represents the ownership stock in a business, and is measured as assets less liabilities. This financial capital represents wealth, and can be utilised to acquire further physical capital in the form of increased assets for use in the business.

In classical economic theory, capital is one of the factors of production (along with land, labour and entrepreneurship). Economic capital usually has the following features:

- It is man-made (in contrast to natural resources such as land);
- It can be used to produce other goods, and
- It is not used up in the production process (in contrast to raw materials and other consumables).

The common factor in the abovementioned definitions is the idea that capital has an element of permanency, and can be used to perpetuate and expand a business. This concept of producing increased capital is known as capital accumulation (or investment), and is fundamental to this study.

The term “capital”, although used throughout the Income Tax Act¹, is not defined therein. Until the introduction of capital gains tax in 2001, receipts and accruals of a capital nature were not subject to income tax by virtue of the definition of “gross income” in section 1 of the Act (the starting point for all income tax calculations)². The legislation fails to define exactly what constitutes a receipt of a capital nature, leading to a wealth of case law on this subject.

Judges in the cases referred to relied strongly on the financial and economic understandings of capital in order to conclude on the amounts in question. The tests include the intention of the taxpayer, whether or not the amount accrues in a scheme of profit-making, the length of time the asset is held and the nature of the taxpayer’s business. Distinction is also made between “fixed” capital with an element of permanency, and floating capital such as stock. The latter distinction arises from the classical economist David Ricardo.

It is clear that the idea of capital for tax purposes is directly related to the characteristics identified in accounting and economic theory. Permanent or semi-permanent assets which are held to produce other goods and can be utilised to expand the physical capital of a business or individual were distinguished from normal income for tax purposes – the famous idea of taxing the “fruit” (income) rather than the “tree” (the capital, or income-producing asset)³. Capital is utilised to produce income, which is then taxed via the Income Tax Act.

¹ Income Tax Act No. 58 of 1962

² Gross income is defined as “...the total amount, in cash or otherwise, received by or accrued to or in favour of...excluding receipts of a capital nature”. From this initial amount, a taxpayer’s final tax liability is calculated via the adjustments legislated in the Income Tax Act (for example, the subtraction of exempt income, allowances and deductions).

³ Refer the judgement in *CIR v Visser*, 1937 TPD, 8 SATC 271

1.3 The Definition of Capital Gains

Capital gains occur when the value of a capital asset as defined increases from its initial cost due to market forces or inflation. Whilst the gains are unrealised, they are not subject to taxation. In other words, increasing property values do not result in taxable gains for property owners until the property is realised, or sold. Once realised, the accrued gain is subject to tax in terms of the relevant legislative provisions. Decreases in asset values give rise to capital losses in the same way.

The concept of capital gains relates to the financial and economic definitions of capital via the abovementioned theories of capital accumulation and wealth creation. Increases in asset values allow the owner of the asset to accumulate capital and expand their wealth. The disposal of an asset, and reinvestment of the proceeds in new asset or assets is in itself an act of capital accumulation and formation. This concept forms the basis of this study in evaluating the international evidence of the effects of capital gains tax.

1.4 Arguments For and Against the Taxing of Capital Gains

The debate over whether or not capital gains should be taxed is one of the oldest arguments in taxation. Proponents of capital gains tax depend on the definition of income developed by economists Robert M. Haig and Henry Simons, which defines income as all consumption during the course of a year plus the change in net worth. This argument can be summarised with the phrase “a buck is a buck”; gains made by selling appreciated assets should not be taxed differently than the income returns from those assets.

Opponents argue that as asset values (with the exception of collectibles such as art) are merely a function of the income that will be produced by those assets, and that such income will be subject to income tax, taxing increases in asset values results in double taxation. Furthermore, by cutting branches from the tree, less fruit is available in the future – taxing capital gains therefore decreases future income which may be taxed, decreasing potential tax revenues.

The arguments for and against capital gains tax are grounded in both financial reality and economic theory. This study does not attempt to conclude on this contentious debate – instead, it attempts to measure the effectiveness of taxing capital gains in the broader context of the South African economy.

2 THE SOUTH AFRICAN CAPITAL GAINS TAX

2.1 Reasons for Introduction

The South African Revenue Service (SARS) Guide to Capital Gains Tax, issued in February 2000, outlined SARS' stated reasons for the introduction of a capital gains tax. The absence of a South African tax on capital gains was deemed to create "distortions in the economy", via the encouragement of taxpayer's to convert taxable income into non-taxable capital gains. It was government's opinion that "sophisticated" taxpayers had engaged in transactions of this nature, with the effect that both corporate and individual tax bases had become eroded. The net result was the decreased equity and efficiency of the South African tax system.

Many of South Africa's trading partners introduced capital gains taxes decades ago. Both the 1969 Franzsen and 1986 Margo Commissions, recommended that capital gains should be subject to tax (findings quoted by the National Treasury in a 2001 briefing). The 1995 Katz Commission suggested that capital gains tax should not be implemented due to its complexity and administrative burden on the fiscus (refer the Third Interim Report of the Katz Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa, 1995). SARS was of the opinion that such burdens were no longer an issue in 2000.

The economic effects of capital gains tax were acknowledged by the National Treasury in a January 2001 briefing by the Tax Policy Chief Directorate to the Portfolio and Select Committees. These include negative outcomes in respect of capital formation, risk taking and investment. These aforementioned negative aspects are able to be managed via the capital gains tax legislation itself, specifically using a

choice of options in respect of base costs⁴, exemptions⁵, roll-over relief⁶, inclusion rates⁷ and rates structures⁸. Furthermore, SARS quoted the “relative certainty in respect of the principles and characteristics of [capital gains tax]” as a factor that would lessen economic distortions.

The Finance Minister has stated that capital gains tax was essential to the broadening of the tax base, due to the appreciation of what he termed “investment assets” going untaxed. He noted that proponents of arguments against capital gains tax, whose main point of contention was small tax receipts therefrom, ignored the fact that the capital gains tax served as a “backstop” for income tax. The point that taxpayers had avoided taxation through the “artificial re-characterisation of ordinary revenue” was again raised.

The first principle underlying the capital gains tax was said to be fairness and economic efficiency. According to Manual:

“Capital profits are economic profits just like ordinary revenue. Both represent a full accretion to net wealth. In other words, taxpayers should bear similar tax burdens regardless of the form of wealth creation. Investors who earn share gains should be

⁴ The initial expenditure on a capital asset, as legislated in the Income Tax Act. Any amount of proceeds derived from the sale of the asset, which exceeds the base cost, results in a capital gain (subject to certain adjustments). Should the base cost exceed the proceeds, a capital loss would result.

⁵ The legislation allows certain exemptions from capital gains tax in specified circumstances. Examples include the first R1 million of capital gains derived from the sale of a primary residence, and the R10 000 annual exemption granted to all natural persons.

⁶ In certain circumstances, the calculation of a capital gain on the sale of an asset is deferred to a future date. This may occur where an asset is transferred within a group of companies. The gain is therefore “rolled over” to the subsequent sale.

⁷ Capital gains are included in a taxpayer’s taxable income at different rates, depending on the nature of the taxpayer. Companies include 50% of their capital gains, whilst individuals include 25%.

⁸ Certain countries utilise scales of tax rates for capital gains, depending on the holding period and the nature of the asset. Current South African legislation does not provide for such rate structures.

subject to tax to the same extent as salaried employees earning wages. CGT also is important as a matter of perception as international evidence suggests that capital gains most often arise in the hands of the wealthy”.

The second major principle was said to be international competitiveness. The Minister stated that introducing a tax on capital gains was consistent with the international practices of many OECD countries. Emphasis was placed on the use of a capital gains tax regime in developing countries, including Brazil, Chile, Malaysia, and Thailand. Manuel dismissed the argument that the international trend was away from capital gains tax, stating that “full research” had not evidenced such a trend.

The South African capital gains tax legislation was described as internationally competitive, with the 50% and 25% inclusion rates of capital gains in taxable income for companies and individuals respectively, as well as the granting of exemptions to individuals (on an annual basis), on the death of natural persons, on the sale of a taxpayer’s primary residence, on intra-group transfers and in situations of “involuntary disposal” cited as evidence of this.

2.2 General Provisions of the South African Capital Gains Tax

The South African tax on capital gains was introduced in 2001. The name capital gains tax is a misnomer – the tax itself is not a tax on capital which is separate from normal income tax. Section 26A of the Income Tax Act includes the taxable capital gain or loss of a taxpayer in that taxpayer’s taxable income for the year of assessment in question, and normal income tax is calculated on the total taxable income. The importance of this inclusion in taxable income is discussed elsewhere in this study; however, it is noted that the effect of this inclusion is to inflate a taxpayer’s normal tax payable for a year of assessment, increasing their effective rate of tax for that year. This is distinguishable from certain other countries, where capital gains are taxed at a separate rate. The provisions outlining the calculation methods of the aforementioned taxable capital gain or loss are contained in the Eighth Schedule to the Income Tax Act.

South African residents are liable for capital gains tax on the disposal of their worldwide assets, whilst non-residents are liable for capital gains tax on the disposal of immovable property in South Africa as well as the disposal of any assets of a “permanent establishment”⁹ in South Africa. Foreign investors carrying on business in South Africa can therefore expect capital gains tax liabilities upon disinvestment.

⁹ The term “permanent establishment” is defined in Article 5 of the Organisation for Economic Co-operation and Development (OECD) model of double tax agreements. Briefly, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. It includes, *inter alia*, a place of management, branches, offices, factories and workshops. The Article lists certain types of activities which do not constitute a permanent establishment – these include the activities of independent agents operating in the normal course of business.

Capital gains tax arises on the “disposal” of an “asset” as defined in the Eighth Schedule to the Income Tax Act. The definition includes property of whatever nature, whether moveable or immovable, corporeal or incorporeal, as well as of rights or interests of whatever nature in such property. The definition of “disposal” is similarly wide, including an exhaustive list of actual events, as well as events which are deemed to be disposals.

The deemed disposals are particularly onerous, as they include situations where people cease to be tax residents of South Africa, or where assets of permanent establishments in South Africa cease to form part of the permanent establishment. The effect of the deemed disposal is that the taxpayer is deemed to dispose of his assets at their market value¹⁰, and then immediately reacquire them for that market value.

The effect of this is to trigger a potentially large capital gains tax liability when investors attempt to move their assets internationally without an actual sale. Other examples of deemed disposals include the nature of assets changing from capital to trading stock, the reduction or disposal of debt, disposals by spouses married in community of property, donations and sales to and from deceased estates.

On the disposal of an asset, the capital gain or loss is calculated as the difference between the “proceeds” accruing to the taxpayer and the “base cost” of the asset. The base cost of the asset is determined via the provisions of the Eighth schedule, but simply put it is the cost of acquiring the asset plus all improvement costs. For pre-valuation date assets (i.e. assets acquired prior to 1 October 2001), the base cost at 1

¹⁰ This term is defined in the Eighth Schedule to the Act, and for the purposes of the situation discussed is the price that could be obtained between a willing buyer and seller in an open market.

October 2001 (the date on which capital gains became taxable) had to be determined by the taxpayer using certain prescribed methods and submitted to the South African Revenue Service. It is noted that the base cost of an asset for the purposes of South African capital gains tax does not change with changes in price levels – in other words, capital gains are not “indexed” for inflation purposes.

Certain exclusions from capital gains tax are provided for by the legislation. These include the first R1 million gain on the disposal of a taxpayer’s primary residence, personal-use assets (i.e. assets utilised solely or mainly for purposes other than trade), retirement benefits, long-term insurance, debt defeasance, small business assets, the exercise of options, compensation for injury and income obtained from gambling competitions (conducted in terms of the laws of the Republic).

The Eighth Schedule also provides for certain situations where capital gains tax does not arise on disposals, but the base cost is merely “rolled over” to the new owner. These provisions apply to situations involving, *inter alia*, expropriations, investment in replacement assets, transfers between spouses and certain intra-group corporate restructuring transactions.

Certain corporate restructuring provisions were introduced as sections 41 to 47 of the Act. The purpose of these provisions was to allow certain group restructuring activities to occur without attracting capital gains tax. The transactions considered were, *inter alia*, company formations, “share-for-share” transactions, intra-group transfers, unbundlings, amalgamations and liquidations. Most of these sections do not apply to foreign companies, and in most cases have onerous anti-avoidance provisions

and the requirement that the transactions only occur in “groups” (as defined in section 1 of the Act¹¹).

Lastly, it is noteworthy that the taxable capital gains of corporates, individuals and trusts are subject to specific inclusion rates in the taxpayer’s taxable income. Natural persons and trusts are taxed on 25% of their capital gain, whilst companies and other entities are taxed at 50%. Individuals are currently entitled to an annual exclusion of R10 000 of total capital gains, increased to R50 000 in the year of their death.

¹¹ Briefly, a “group” of companies for income tax purposes is generally two or more companies where a holding company directly holds 75% or more of the ordinary share capital thereof. Recent amendments to the legislation have lowered the direct holding requirement to 70%.

3 CRITICAL FRAMEWORK OF THE STUDY

3.1 The functions of government and fiscal policy

Fiscal policy refers to government's decisions relating to the level of expenditure, debt and taxes, the balances between these components and how they change over time (Collignon, 2005). In order to understand the effect of fiscal policy, it is necessary to refer to the classical theory of the economic functions of public finance and fiscal policy. Musgrave (1959) identified these functions as allocation, stabilisation and distribution.

3.1.1 Allocation

The allocation function refers to measures taken to overcome the inefficiencies of the market system in the allocation of resources. This is achieved via the activities of government which alter the output of the economy, the levels of government expenditures on public goods and services and regulatory policies.

The allocation function is governed by the social needs of a country. The government provides public goods such as the legal system, defence, infrastructure and public recreational areas which are not provided by the private sector. Musgrave argued that these goods should be financed by the people who use them, and that government is able to coerce this finance from the citizens of a country by means of taxes (Musgrave, 1959).

3.1.2 Redistribution

This function refers to measures taken to redistribute income and wealth in order to move towards the distribution that society considers equitable. Government is obliged

to identify causes of inequity and utilise targeted taxation and expenditure policies to correct them.

There are several rationales for redistribution. One such rationale is that fiscal policy should be utilised to improve the living standards of the poorest members of society, and ensure an acceptable minimum standard of living for all citizens. Alternatively, a government may seek to bring about equality in the distribution of income.

Whilst the rationales noted above for the redistribution and equity policies (i.e. improvement of living standards and distribution of income) may seem similar, Collignon notes that they are mutually exclusive, and require different government options in order to achieve the goals. Social security and the improvement of standards of living, which are major concerns in the South African context, may be achieved via targeted government expenditure on key areas (financed through the collection of taxes). Equality may be achieved via “wealth confiscation” taxes such as those targeted at investment income and capital gains (which are most concentrated in higher income groups) and redistribution via government grants. These two functions of fiscal policy have not been historically noted to be achieved via one fiscal strategy – in other words, redistribution policies achieving equality may not necessarily provide sustainable help for the poor (Collignon, 2005).

3.1.3 Stabilisation

The stabilization function is performed via fiscal and monetary policy measures which smooth out cyclical fluctuations in the economy and ensure optimal levels of employment and price stability. Musgrave (ibid) argued that economic stabilisation via focused fiscal policy was the fundamental function of public finance.

Government expenditure and tax policies are assumed to respond automatically to changes in economic activity. These responses may be automatic (such as downward adjustments in tax revenue budgets when incomes decrease due to economic slowdown) or focused actions by government (such as spending on unemployment benefits when employment levels are low). Government may also formulate expansionary fiscal policies aimed at increasing demand and output in the economy either directly, through greater government expenditures, or indirectly, through tax reductions that stimulate private consumption and investment spending.

In a United States study, Auerbach and Feenberg (2000) have estimated that automatic tax stabilisers in the United States are able to mitigate as much as 8% of the impact of economic downturns on gross domestic product. Furthermore, Fataf and Mihov (2001) state that recent studies have provided strong evidence that fiscal policy can have significant effects on the United States economy - Blanchard and Perotti (1999) and Burnside, Eichenbaum and Fisher (1999) document that changes to fiscal policy induce changes in output, consumption, investment or employment.

Government must take fiscal policy measures aimed at the achievement of specific economic goals in order to perform the functions described above. Tax rates and expenditure levels can be changed and redeployed in this regard, depending on the desired effect.

3.2 Historical South African Fiscal Policy Goals

In 1996, the goals of the then existing Reconstruction and Development Programme included the elimination of poverty and deprivation, such goals to be undertaken via macroeconomic stability, sustained economic growth and increased competition (Trevor A Manuel, Minister of Finance – Paper delivered to the Bureau for Economic Research Conference, 8 October 1996). Economic growth was also tabled as a means to increase employment levels, a resultant effect that was seen as the central focus of the country's macroeconomic strategy. Around that central focus, the major goals of South Africa's macroeconomic strategies were redistribution of income and opportunities, the provision of social services and increased productive employment.

Manuel outlined the broad policy objectives for the South African economy as promoting a faster rate of growth of incomes, increased employment and balanced, equitable claims on the available economic resources (Trevor A Manuel, Minister of Finance - Presentation to the Standard Bank South African Financial Markets Conference, 7 November 1997). Manuel identified the volatility of capital flows, but commented that economic expansion would be facilitated through the mobility of capital and the efficiency of capital markets. He concluded that the existing policy framework, which recognised these factors, would attract foreign investment and lead to economic growth.

The core South African fiscal and economic policy goals remain economic growth, poverty reduction and job creation. On the face of it, South Africa's core fiscal policy goals have remained largely unchanged over the past decade.

The 2005 Budget Speech referred to fiscal foundations which would give rise to increased investment and productive capacities, the creation of jobs and the overall growth of the revenue base. The existing fiscal policy base, which remains unchanged from that speech to the time of this study, was described as one which was designed to underpin growth and investment. The elimination of barriers to business development and job creation were also identified as an area to be addressed, along with the attraction of foreign investment and external capital, the deepening of financial markets and increased trade relations.

4 INTERNATIONAL EVIDENCE OF THE EFFECTS OF A CAPITAL GAINS TAX

4.1 Global Competitiveness, Economic Growth and Capital Formation

Economic theory acknowledges the flow of international capital as a driver of economic prosperity. Foreign capital investment naturally flows to areas with high capital returns and low capital transaction costs. The United States, for example, is burdened with one of the highest effective capital gains taxes of any industrial nation (partly due to the lack of an indexing system), which has resulted in reduced capital outflows since the 1990's. Economists Robert N. McCauley and Steven A. Zimmer of the Federal Reserve Bank of Boston found that capital costs (including taxes) for various standard investments in plant, equipment, research and development, and land in the United States are higher in almost all cases than in the United Kingdom, Germany, and Japan (McCauley & Zimmer, 1999).

A study performed in the United States in the early 1990's found that abnormally high capital costs (a component of which is the tax on disposal) are a barrier to growth and global economic leadership. The researchers concluded that if state policy fails to stimulate investment and renders a country's industries unable to match the productivity performance of competitor countries, particularly industrial nations, there is no question that the country in question would become less competitive in world markets (Manufacturers Alliance for Productivity and Innovation, 1991).

The study ultimately stated that "...in sum, a country cannot compete and win in the global economy of the 21st century with a tax code that repels capital". Brenner

(1999) concurs with this point, noting that financial capital is mobile, and tends to flow out of high-tax jurisdictions.

Research by Fletcher (1993) into the socio-economic effects of reduced capital gains taxes discovered that reductions attract investment funds to capital-starved areas and minority groups. The United States experience revealed that when capital gains tax rates fall, investment flows back into areas most in need of such investment, such as underdeveloped urban and rural communities. A report by the members of the U.S. Civil Rights Commission found that after 1978, when the US capital gains tax was reduced from 49 percent to 28 percent, "the number of black-owned businesses increased in a five-year period by one-third." Fletcher's study offered the view that, based on the historical results, fiscal policies that impose taxation on "success" in the form of capital growth ultimately retard the growth of enterprises and decrease opportunities for employment in historically capital-starved areas.

In a document presented as part of a study to the Joint Economic Committee of the United States Congress, Knight (1997) noted that a country's economic growth depended largely on two factors: the quantities of available inputs, such as capital and labour, and the productivity of those inputs. Economic growth cannot occur unless the quantity of inputs increases, productivity improves, or both. This led to the observation that investment in capital is therefore crucial to economic growth, because it increases the amount of capital available in the economy and may also enhance labour productivity (because capital and labour are productive complements – see below). The critical link between investment and economic growth is a widely accepted economic principle. Capital gains tax therefore impacts economic growth if it is a deterrent to investment.

The aforementioned presentation by Knight, which *inter alia* addressed the diminishing growth of capital investment, stated definitively that such diminishing growth could be partly attributed to high costs of capital. As the cost of capital measures the return that an investment must yield before an entity is willing to undertake the investment, and further that high capital gains tax rates decrease the return on investment (being an increase in the underlying cost thereof), such taxes depress the overall level of investment in the economy. A reduction in capital gains tax would lower the cost of capital and stimulate investment.

Knight concluded that "...the effects of increased capital formation would reverberate throughout the economy in the form of higher wages, rising living standards, job creation, and economic growth and provide a global competitive advantage in terms of attracting foreign capital". Such increased formation would be a direct concomitant of a decrease in taxes on capital gains.

Poddar (2000) noted that certain tax jurisdictions, including the Nordic countries (Sweden, Denmark, Norway and Finland), have coupled lower marginal tax rates on investment income with the decrease or removal of capital gains taxes. Previously, these countries imposed very high tax rates on investment income, which, in conjunction with further taxes on capital gains, led to an exodus of capital in the early 1990's. These countries had to significantly reduce their effective costs of capital in order to remain competitive with the rest of the world. According to economist Allen Sinai (1997), the trend is toward a lower, and in some cases a zero, capital gains tax in most countries around the world.

Kugler and Lenz (2000) present empirical evidence on the effect the elimination of the capital gains tax has had on income in Switzerland. Whilst the federal government

of Switzerland does not impose a capital gains tax, some administrative divisions do. Of these, some had eliminated the tax, giving the authors a unique opportunity to examine the economic effect within the country.

Kugler and Lenz (*ibid*) calculated the trend in the economic growth rates before and after the elimination of the capital gains tax. They then calculated average growth rates for the two groups. They found that where the tax was eliminated, there was an average short-term 2.2% increase in the level of national income. The long-term yielded a 3.1% increase.

In a 1999 presentation performed by the American Council for Capital Formation, the important point regarding the mobility of capital was noted. In order for capital to move freely into areas where it is most efficiently utilised (a concept that underpins the concept of capital investment as a means of economic growth), barriers to this mobility must be removed by market forces and, where necessary, government intervention via fiscal measures. A tax on capital gains can be a countermeasure to free capital flows as it has an impact on disinvestment.

The abovementioned presentation used the simple, yet effective inference that an investor who wishes to sell a portion of his or her assets, and reinvest the proceeds into better performing assets, must pay a tax on the capital gains arising on the shifting of wealth from one asset to another - even though the proceeds are never used for consumption purposes. Thus, less capital is available for the new investment, leading to a lower effective rate of return. This example clearly illustrates that the taxation of capital gains retards the mobility of capital, and disallows the movement of capital to areas where it is most efficiently used.

The above view was reiterated in the Canadian context by Brenner (1999), who bemoaned the high marginal tax rates on capital gains in Canada as a serious impediment to economic prosperity. Brenner states that "...the prosperity of a country really depends on its ability to move funds and labour away from traditional and unproductive uses to newer and potentially higher yielding ventures".

The concept of capital immobility is most widely referred to (in the context of capital gains taxes) as the "lock-in" effect (*inter alia* Moore and Sylvia, 1995 and Brenner, 1999). Taxes on capital gains have the effect of locking investment into certain areas, due to the propensity of investors to avoid taxation by realising investments and re-investing in other areas. This effect is compounded by the fact that investors who wish to switch investment areas, but must seek a substantially higher rate of return to recover the amount of the principal investment lost to taxation.

It should be noted that this effect may be mitigated by certain measures within the relevant tax jurisdiction, such as the deemed disposal on the taxpayer's death. The South African and Canadian legislations include such provisions. However, these mitigating provisions usually involve "unlocking timelines"¹² that are economically inefficient in terms of speedy capital mobility.

Moore and Sylvia (1995) note that virtually all economists agree that capital formation is essential to the instigation and restoration of economic growth. The key issue in the context of this study is the extent to which a decrease in the effective rate of capital gains tax would affect the total capital formation in a given country.

¹² The "unlocking" of capital occurs when the asset in question is disposed of, liquidating the capital for further investment. Examples of locked-in value include property, which creates unrealised gains that are only realised as real value when the property is disposed of.

In a 2001 speech to the Taxpayers Association of Europe, Dr W F Duisenberg, President of the European Bank, noted that taxation is an important consideration in the formulation of economic and financial policy, due to its effects on prices, social security and economic growth. Dr Duisenberg also noted the relationship between taxation policy measures and productive labour. He concluded that, in addition to governmental expenditure reform, the control of taxation measures is a key factor in the achievement of medium- to long-term fiscal goals.

In support of the above, the United Kingdom Treasury issued documentation in the late 1990's which reinforced its focus on the economic cycle as a factor in fiscal policy setting. The document recognised the effect of overall fiscal policy on various economic areas, including those discussed above, but with particular reference to economic growth (United Kingdom Treasury, undated).

Bloomfield (1995) noted that, overall, the cost of capital in United States industry had risen appreciably since the United States 1986 Tax Reform Act. He notes further that although other measures introduced by that Act, including minimum corporate taxes, alterations to depreciation allowances and the elimination of certain tax credits had contributed to the rising capital costs, the tax penalty giving rise to the biggest increase was undoubtedly the increase in the capital gains tax. He concluded that the tax burden imposed by the capital gains tax had widened the gap between the income produced by a capital investment and the after-tax return to the investor.

Moore and Sylvia support Bloomfield's results, stating that the unfavourable tax treatment of capital investment had caused an "observable slowdown" in growth rates of United States capital formation - between 1986 and 1992, business fixed investment had halved. Furthermore, business investment in equipment had fallen by

more than 30% over the same period. From 1992 onwards investment growth had returned, but the growth rates were significantly lower than those observed during the early 1980's, prior to the increased capital gains tax rates.

Henderson (1989) estimated that the 1986 increase in United States capital gains taxes was directly responsible for roughly half of the increased costs of capital noted by Bloomfield. Using stochastic techniques to compute the desired corporate capital stock, she determined that the capital gains rate increase reduced the level of corporate capital stock by between 2 and 4 percent.

A study by Kopcke (1989), at the time an economist with the Federal Reserve Bank of Boston, isolated the additional cost of capital attributable specifically to the capital gains tax rate of 28 percent that was effective at the time of his study and persisted into the 1990's. The study investigated the rate of return required on various forms of equity under the prevailing current capital gains tax structure, assuming a 6 percent inflation rate.

The results of the study, which were generally replicated by Bloomfield in 1989 and Robbins in 1990, demonstrated an important linkage between the rates of capital gains tax and capital formation. The main finding was that the additional tax burden of capital gains tax increases the cost of equity financing and deters the growth of corporate enterprises. That finding was again confirmed in 1990 by a US Chamber Foundation study, and was cited in support of a proposal to reduce the capital gains tax rate from 28 to 20 percent. Hendershott, Won and Toder (1990) developed the model which simulated economic conditions in response to various levels of effective tax rates on capital gains. When the model lowered the capital gains tax rate to 15 percent, the model output was a noticeable decrease in the costs of capital to both the

corporate and non-corporate business sectors. The researchers stated that those results had specific consequences for capital formation.

Notwithstanding the effects on capital stock, the fact that capital gains taxes are effectively transaction costs has a direct effect on financial markets as well. In efficient capital markets, if an external factor (such as a “tax cost”) causes one type of investment to become less attractive, and another type to become more attractive to investors, this shift will be reflected in share prices. This would apply where high-growth stocks are avoided in favour of high-yield investments (see below).

Milligan, Mintz & Wilson (1999) note that capital gains taxes influence a firm's cost of capital, due to the fact that they change the rate of return that an external investor in the firm's equity would require. The price that the investor is willing to pay is therefore altered by the tax; the tax is therefore capitalised into the price of the share, and further into the valuation of the firm in question.

Sinai (2000) pointed out that reductions in effective capital gains tax rates on individuals would raise the after-tax return on equity to shareholders. This would in turn reduce the after-tax weighted average cost of debt and equity, leading to an appreciation in stock markets due to an increased propensity for individuals to shift their investments toward equities in order to increase their net worth and wealth.

Guenther and Willenborg's 1999 study into the effects of capital gains taxes on stock prices shows that the issue prices of their sample of small business stocks after reductions in effective capital taxing rates were significantly higher than the issue prices before the reduction. The authors concluded that "nearly all of the future tax

benefits from the rate reduction were passed on to the issuing corporations in the form of higher stock prices rather than retained by investors."

A further study by Lang and Shackelford (1999) examined the resultant stock price movements following a decrease in the United States capital gains tax rate from 28 to 20 per cent. The study demonstrated that dividend yield and share prices moved inversely to each other as a result of the rate cut. The share prices of firms that were not paying dividends at the time of the cut increased by six per cent more than the prices of firms that were declaring dividends when measured over the studies five-day test period.

The authors of the study noted that their results illustrated the relationship between dividend and capital gains income. If capital gains are taxed at a lower rate, then companies that distribute a large portion of their income through dividends are less attractive to investors, due to the fact that the market value of a company is equal to the after-tax present value of the expected future dividends plus expected future capital gains. There is thus a greater incentive for companies to retain more earnings for productive investment (rather than paying out dividends), which in turn translates into higher after-tax value for their shareholders and a lower corporate cost of capital (higher market value) for the companies.

The depressive effect on stock markets of the introduction of capital gains tax was highlighted in Taiwan in 2005. The Taiwanese exchange continued to climb following the announcement of the possible introduction of a capital gains tax on institutional investors, boosted by foreign investment. Fund managers attributed the gains to "...the slim possibility that the tax would be introduced... as President Chen Shui-bian's administration may not want to depress the market amid a slowing economy"

(Wu, 2005). The understanding that the introduction of capital gains tax would depress trading volumes and market levels, whilst simultaneously discouraging foreign investment, was a major obstacle in the introduction of the proposed tax.

In contrast, the proposed removal of the Indian capital gains tax in favour of securities transaction tax (essentially an indirect tax levied on all transactions) resulted in a wave of encouragement from long-term institutional traders and small investors. Day traders and brokers were less supportive – not surprising, given their short investment horizons (Singh, 2004). Long-term investors indicated a strong propensity to increase trading with the removal of taxes on capital growth.

Analyses supporting the deterrent effect of capital gains taxes on long-term stock market investors have also been made in the Swiss (Dietz, 2003) and Israeli (Sauer, 2003) contexts.

In a 2001 article by the US Heritage Foundation, it was stated as a generally accepted fact that cutting capital gains tax rates will, based on past experience and research, cause asset values, including stock markets, to rise. Whilst some supporters of capital gains tax state that lowering capital gains tax rates will cause the stock market to fall (because investors would sell their investments), the opposite is true. Lowering capital gains tax rates increases the prices of stocks and other assets, as stock markets reflect “the collective actions of people looking forward”. The authors concluded that lowering the cost of capital by decreasing tax rates on investment returns will increase asset values.

The preceding trends and concomitant effects, although presented in the context of stock markets, are equally true to any income-producing investment. Property and

money-market investments, which would be valued based on the expected future income streams, would automatically capitalise into their inherent values a decreased terminating cash flow caused by a capital gains tax on sale. Based on the research presented above, it can be generally accepted that this capitalisation effect would have a depressing effect on the asset markets in question when capital gains tax rates are introduced.

4.2 Employment

In the United States, a number of economic researchers have attempted to estimate the direct employment gain or loss arising from changes in the rate of capital gains tax, via the use of economic simulation models. Once such study was performed by Gary and Aldona Robbins (1994), who performed an economic simulation attempting to estimate the number of new jobs and the increase in economic growth that would result from a cut in capital gains tax rates (which was at the time under consideration by US congress).

They concluded that the proposed decrease in the effective tax rate on capital gains would reduce the aggregate US cost of capital by 5%, increase the total capital stock by \$2.2 trillion and increase national output by \$960 billion; all such increases to occur within a 7-year period from the time of the decrease. The most important labour statistic garnered from the study was that the increased capital stock would result in the employment of an additional 720 000 people.

It has been held that the results of the Robbinses study are generally more optimistic than other studies of the same nature. However, most of the other studies have concluded that a cut in the rate of tax on capital gains would definitely result in

positive movements in employment and gross national product (*inter alia* Bloomfield, 1989, Kopke, 1989 and Sinai, 1995).

International research on the link between the taxing of capital and job creation has clearly indicated that the key link between the two is business investment. Increased investment leads to increased capacity and increased demand for labour. A press release by United States senator Wayne Allard in 2001 plainly stated that “...Congress needs to adopt pro-growth provisions that address both short and long-term needs of the economy. One provision that does both is a capital gains tax cut... a lower capital gains tax encourages investment and job creation, helping restore economic growth and put America back to work”. In 2003, the Whitehouse Council of Economic Advisors published a document outlining President Bush’s plan to strengthen the United States economy. The document reiterated that job creation depended on a “...robust rebound in business investment”. It stated that “...this is the key factor to creating more jobs—when companies build new factories, they hire workers and boost employment in capital-goods industries”.

The Internal Revenue Service of the United States published the Jobs and Growth Tax Relief Reconciliation Act of 2003 on their website in June 2003. Amongst the provisions of this legislation was a reduction in capital gains tax rates – this was seen as a key component of boosting the labour market and encouraging growth.

4.3 Savings and Investment

Moore and Sylvia, in another aspect of their 1995 study referred to earlier, noted that a related effect of a capital gains tax is to encourage the financing of new business investment through debt rather than equity. This is due to the fact that capital gains taxes are effectively a form of double taxation of the same income in the context of

equity investors— corporate income is taxed when earned, is capitalised into the value of the business when valuing the underlying shares therein, and is ultimately taxed once more when the business owners sell their equity holdings. In contrast, debt financing has no such double-tax effect for lenders, and also involves tax-deductible finance costs for the business itself.

A study by Ballentine (1998) arrived at a similar conclusion. The study sought to quantify the resultant capital gains tax differential experienced by a corporation that finances through an equity issue rather than gearing. Ballentine found that "for the typical holding periods the tax penalty is over 50 percent", implying that equity investors could expect to lose half of their capital growth to taxes in comparison to the return on a debt investment. The study emphasised the negative aspects of such a differential, and questioned the rationale for "imposing a penalty" on investors who were willing to commit equity investments in a project due to anticipated future capital gains, and effectively providing a corresponding tax benefit to the use of debt finance. The effect of a capital gains tax is therefore clearly the encouragement of the advancement of long-term debt investment rather than the participation via the purchase of stock. This has negative connotations for heavily geared companies which cannot afford more debt, or for entities who cannot commit to immediate interest outflows due to lack of cash. This also deters investment in stock markets in favour of money-market instruments.

Mintz (1999) addressed another important aspect of savings and investment in an environment where capital gains are taxed. He suggested that such a tax system discriminates against savings compared to consumption. He explained this by stating that when a person earns income, taxes are paid at that stage. If taxpayers expend the

remainder of the income via consumption, no further direct taxes would be payable on that income. Should they invest the income into any vehicle such that the income becomes capitalised, they may be taxed again on the exit from that vehicle. Taxpayers therefore pay additional tax on their investments. Ultimately, saving and investment are discriminated against under such an income tax regime, when compared to consumers.

A report by the Canadian Standing Senate on Banking Trade and Commerce (2000), which dealt specifically with the taxation of capital gains, also identified the above concept outlined in Mintz's study. The report stated that the concept, referred to broadly as the "double taxation of savings", is not unique to the taxation of capital gains but the taxation of any return from capital. The report stated that "the deferral of consumption is subject to tax in a way that current consumption is not".

The Canadian report also identified a general element of double taxation that occurs when the income from assets is taxed along with the capital gains on those assets. Asset values reflect expected returns, and capital gains are largely based on an expectation of higher future returns. In short, a valuation giving rise to an increase in the value of a capital asset is the present value of the expected increased returns. If the returns are taxed, a capital gains tax constitutes a second tax on the same income.

Comments by Spindler (2001) underscore the concepts noted above. Spindler noted that current period income could be saved, rather than consumed, and invested in capital assets at an internal rate of return equal to the going external capitalisation rate for that class of assets. The expected future earnings on the asset would increase, and directly increase the value of the asset by the amount of the saving or investment, via capitalisation of that amount into the asset value. Taxing that capital gain is therefore,

according to Spindler, "...equivalent to attempting to tax income at a higher rate if saved [or invested] than if consumed. A growth-oriented government would presumably want to do exactly the opposite".

4.4 Revenue Effects

The usual argument for a capital gains tax is the government's need to raise revenue. Sinai (2000) states, however, that contrary to the beliefs and subsequent taxation policies of most governments, the first significantly positive effect on tax receipts is likely to come from the one-time "unlocking" of capital funds, combined with increased realisations, which would most likely follow a significant *reduction* in capital gains tax rates, rather than an increase therein.

In an extension of this discussion, Mintz and Sinai agreed that when considering a long-term horizon in the Canadian context tax revenues from the taxation of capital gains would decrease. However, Melligan, Mintz and Wilson (1999) concluded that the idea that capital gains tax cuts would be self-financing in the long term "...could not be supported empirically".

In contrast, Sinai (2000) reported that a positive effect of a capital gains cut would be an indirect increase in overall tax revenues coming from higher spending, greater employment, income, profits, stock markets and wealth creation. These increases would, at least partially if not fully, compensate for potential losses in government capital gains tax receipts in the long run. This argument, coupled with the first one noted above, was presented as evidence to the Canadian government that a decrease in Canadian capital gains tax rates would result in increased tax revenues in both the short- and the long-term.

Moore and Sylvia note that, in general terms, it is accepted that decreases in effective rates of capital gains tax would have both positive and negative effects from a revenue-generating point of view. Government revenue is lost via sales that would have occurred regardless of the rate of tax involved, and therefore benefit from lower rates, as well as reduced current-period trading in anticipation of future tax cuts (i.e. deferring the disposal event to a period where effective tax rates will be lower). Conversely, a decreased rate would gain revenue through the short-term “unlocking” of assets that would not have been sold otherwise, or not at all (until the death of the taxpayer); an increase in reporting of income (i.e., less tax evasion); an increase in the value of stock and other capital assets traded over the long run; and an increase in long-term economic growth from the higher capital formation, which would raise tax collections from income taxes, payroll taxes, and other sources.

To quantify the effects of static capital gains tax rates, it was estimated by the US Congress Joint Committee on Taxation that the Hatch-Lieberman bill passed in the US Senate, which vetoed the possibility of indexing for inflation for capital gains tax purposes, resulted in a \$53 billion revenue loss between 1995 and 2002 as a result of unreported sales, or transactions that were not undertaken due to the capital gains tax regime.

Grubel (2000) supports the above. He notes that the Canadian Department of Finance had published estimates of the output losses per extra dollar of tax levied. While those estimates excluded Canadian capital gains tax, Grubel purports that the corporate income tax could stand as a proxy for the capital gains tax, since both are levied on capital and both create very similar incentives and opportunities to avoid them. Grubel quotes the estimates, published by the OECD in 1997, as suggesting that an extra

dollar raised by the corporate income tax would cost the economy \$1.55 in output. The analogous figures are \$0.56 for the personal income tax, \$0.27 for the payroll tax and only \$0.17 for the sales tax. He concluded that the data suggested strongly that the elimination of the capital gains tax and a simultaneous increase in other taxes to maintain total revenue would cause national income to increase.

Grubel added that the idea that taxing capital gains would increase revenue was only correct in a static view of the world, citing evidence that lower capital gains taxes have increased the quantity of disposals and resulted in higher revenues. The evidence cited held strongly for the short run, but Grubel notes that “many analysts insist that it also works in the longer run because of the effect of lower capital gains taxes on economic growth”.

4.5 Wealth Creation and the Taxation of Illusory Income

The concept of “indexing” the base cost of capital assets – i.e. notionally decreasing the quantum of capital gains based on the historical behaviour of national price levels – has been included in the tax systems of certain countries that impose taxes on capital gains. The concept is lauded by economic professionals, given that the absence of this form of relief results, in the economic sense, in the taxation of illusory income.

Grubel (1999) stated that, in real terms, there is no gain when capital gains track inflation. He went on to say that the taxation of capital gains does not recognise this, and taxes these illusory gains - effectively becoming a “confiscation of wealth”.

Whilst opponents of indexation correctly identify that indexation as a measure is practically difficult to implement, the fact that the taxation of inflationary nominal gains is an impediment to wealth creation is unarguable. Grubel and others note that

most countries do not adjust the tax treatment of capital gains for inflation, and the few countries that did are removing these measures due to the technical difficulties of indexation, no small part of which is the lack of reliable inflation figures for a given period.

Hall (1995), described non-indexation as “one of the most unfair features” of the US capital gains tax, noting again that it taxes gains that may be attributable only to price changes. He reported that the lack of indexing in a tax system can have “major distortionary effects” on the amounts of capital gains taxes payable by individuals, and can (in extreme but oft-occurring circumstances) lead to an effective tax rate that exceeds 100% of the taxpayer’s real gain.

Wesbury and Given (1995) offered the following example illustrating Hall’s abovementioned concerns: “If an investor purchased a \$10,000 diversified portfolio of stock in 1970 as a retirement nest egg, and that stock appreciated in value at the same rate as the Dow Jones Industrial Average over the next 20 years, then it could have been sold when the investor retired in 1989 for roughly \$28,000. Yet that stock would have had to have been sold for about \$31,000 to have kept pace with the rate of inflation over that 20-year period. Hence, the investor suffered a real loss in purchasing power of about \$3,000 on the stock. Nonetheless, under current law the retiree would have to pay \$5,040 in capital “gains” tax (assuming he is in the 28 percent tax bracket) on an investment that produced a real \$3,000 capital loss. That means that the investor would pay a 129 percent tax rate on the investment”.

Mintz (2000) states that the tax treatment of capital losses¹³ also has a direct impact on a taxpayer's effective rate of capital gains tax. In most global tax regimes, capital losses are not treated in the same manner of capital gains; the losses are only deductible against current or future capital gains, and are carried forward at a zero implicit interest rate. In a previous study, Mintz has also noted that where capital losses are only allowed for setoff over time, there is a "time value loss" associated with the current-period disallowance.

Mintz and Wilson (2000) conclude that, especially in the case of risky assets, effective tax rates can be highly punitive in a tax regime that does not allow the immediate setoff of capital losses against other forms of taxable income. The effect of this is ultimately similar to the example set out above. The capital gains tax therefore effectively discriminates against risk-taking and entrepreneurship by notionally increasing the effective tax rate where losses, rather than gains, are made (unclaimed capital losses would not reduce the effective tax payable in the manner that normal, tax-deductible expenditure or losses would).

Angell's (1993) comments provide a fitting final word on this issue. In outlining methods to reduce the "damaging effects" that are known to result from the taxation of capital gains, Angell states that elimination of the worst aspect of such a tax, being the taxation of "phantom" gains, is the most crucial measure of tax reform. Angell concluded on this issue by stating that "...the tax on real capital gains is a middle-of-the-road bad tax. But the tax on nominal capital gains without regard to whether the gain is real or only the effect of inflation is truly the worst tax".

¹³ Capital losses occur when the proceeds received on the disposal of an asset are less than the cost to the seller (such cost is determined by the prevailing tax legislation).

4.6 Small Business Creation

In the 1997 study presented by the Canadian Joint Economic Committee Study on the Economic Effects of Capital Gains Taxation, the point was made that capital gains taxation further affects economic and employment growth through its impact on entrepreneurial activity and business creation. The reasoning was that entrepreneurship is affected by, *inter alia*, the strength of the incentives (whether tax-based or otherwise) that motivate entrepreneurs to undertake innovative projects, and the availability of capital to the entrepreneur for the purpose of financing projects. The study concluded that the taxation of capital gains discourages innovation, risk-taking, and capital investment, thus diminishing entrepreneurial activity in the economy.

Birch (1981) notes that a potential benefit of reducing the capital gains tax is the diversion of investment funds to new business start-ups, particularly in the high-tech industries (where investments tend to involve high risk but have potentially large investment returns). Birch adds that this effect would ultimately result in job creation.

Judge (1991) collated United States evidence that supports Birch's comments, and illustrates that there is a relationship between the United States capital gains tax and historical investment in promising new firms. Judge's evidence shows compellingly that past reductions in the US capital gains tax rates stimulated the financing and start-up of new businesses – conversely, new business activity stalled after increases in the rates of capital gains taxes.

A 1993 article by Coopers & Lybrand Venture Economics stated that venture capital funds were crucial in industries that are ultimately critically important to the international competitiveness of a country. The article listed examples of such

industries: computer software, biotechnology, computer engineering, electronics, aerospace, and pharmaceuticals amongst them. The authors concluded that the high capital gains taxes present in the US at the time had contributed to the “drying up” of funding sources for promising new firms in those key industries.

Bernstein (1990) indicated that not only are there more small business start-ups and Initial Public Offerings during periods of low capital gains taxes, but the stock of smaller firms appears to outperform that of large corporations. Moore and Sylvia cited 1995 research by Merrill Lynch which demonstrated in the period from 1970 to 1995, small and medium-sized firms had benefited significantly more from reductions in capital gains taxes than had large, established corporations.

Further US data presented by the US National Venture Capital Association in its 1993 Annual Report showed that taxable sources of external investment were “fleeing” the venture capital area, due to the after-tax return for those investors being substantially reduced. Conversely, sources that were not subject to the capital gains tax had increased their participation in venture capital funding.

Moore and Sylvia stated that, at the time of their study, decreases in the effective rates of capital gains tax were critical to United States entrepreneurs and small business owners. Their reasoning for this was based firstly on the fact that most high-risk small business start-ups could reasonably expect to receive the bulk of their initial capital from “informal” non-institutional investors, who would be subject to the capital gains tax. Additionally, as noted above, higher capital gains taxes had historically been associated with the drying up of investment capital for small and growing businesses, whilst lower capital gains taxes had produced substantial increases in business start-ups and financings. Finally, the authors submitted that a capital gains tax cut would

particularly benefit the US's high-technology companies, which had a significantly high need for investment capital in their start-up stages - "...such firms tend to be financed by a combination of informal investors and venture capital - both of which are highly influenced by the capital gains tax rate".

Israel Kirzner (1985) described entrepreneurship as a discovery process. He stated that "...the entrepreneur is innovative and resourceful, a risk-taking individual who discovers otherwise overlooked opportunities. Whereas most individuals are motivated by a known set of economic incentives, such as wages or promotion potential, the entrepreneur is motivated by the potential return that may be earned from entering into a situation with *unknown* outcomes". Based on that definition, Kirzner concluded that if the aforementioned potential returns were taxed too heavily, the entrepreneur's motivation would be reduced. High capital gains tax rates would therefore discourage potential entrepreneurs from new undertakings and innovations.

Finally, Sinai (1999) predicted that reduced capital gains tax rates would result in the formation of more new businesses, due to the fact that individuals would be more willing to undertake the risk associated with start-ups. Sinai added that the lower corporate cost of capital, which is resultant from a higher after-tax valuation of equities, would increase the after-tax return to investors on new investments.

4.7 Effect on Anti-avoidance

Governments often site tax avoidance or evasion as a necessitating cause for the introduction of a tax on capital gains. They state that taxpayers are encouraged to alter taxable income into non-taxable capital profits in order to escape taxation, whether by avoidance (legal) or evasive (illegal) means. The capital gains tax thus negates these tax schemes, widens the tax base and increases revenues by amounts that would

normally be lost to the fiscus. Various commentators have expressed views on this argument.

Goodman (1997) calls this argument (that if capital gains were untaxed, taxpayers would exploit a perceived loophole and pay no taxes) a bad one. He was responding to an article wherein the author states that accounting “alchemy” could turn almost any form of income into a capital gain, and would do so if corporate tax rates were higher than capital gains tax rates. He quotes economic data from a period when the United States rate of capital gains tax was 28% and the top marginal tax rate was 70% - at that stage, collected capital gains were only 3% of US gross domestic product. Furthermore, when the rates were 50% and 20% respectively, collections were about the same. He concludes from these statistics that the opportunities to convert ordinary income into capital gains were obviously fairly limited.

Goodman adds that the idea that capital gains avoid ordinary income tax is erroneous. If income streams are taxed, the assets that they are capitalised into are reduced by the amount of the tax burden. Valuations would therefore decrease and assets, in real after-tax terms, are undervalued.

Auerbach, Burman and Siegel state that empirical work has found little evidence that investors have engaged in significant tax avoidance activities, nor that considerable opportunity to avoid tax is available to them. In a paper using a data set with a large sample of high-income individuals, the authors sought to examine the behavior of those individual taxpayers over time.

The research revealed that tax avoidance was not significantly prevalent, although high net worth individuals were more likely to avoid tax in periods when effective capital gains rates had recently been decreased by the 1986 United States Tax Reform Act. Notwithstanding this, the authors concluded that tax avoidance schemes were only truly effective in the long-term, and that this was not possible given the anti-avoidance legislation in the prevailing tax regime. The effective rate on capital gains was therefore very close to the statutory rate throughout the test period (i.e. tax rates were not artificially decreased using avoidance schemes).

Rahn (2005) uses the Laffer curve¹⁴ to illustrate the level of effective tax rates at which taxpayers become significantly incentivised to seek methods to avoid taxation, whether legal or illegal. The theory generated by the curve stated that decreased effective rates of tax would decrease tax avoidance and evasion, increasing fiscal revenue in the long run. This would occur due to increased savings investment and economic growth, and proved that one argument against capital gains tax would eliminate another argument for it.

Rahn continues by saying that the United States capital gains tax is a prime example of a tax rate which is "...too high to maximise governmental revenue". The unique characteristic of the capital gains tax is that it gives the taxpayer discretion as to when it will be paid. Capital gains tax, unlike other taxes, may be fairly easily avoided by deferring the sale of the asset. This effect and the resultant avoidance is illustrated by Rahn when citing the increase of the effective US capital gains tax rate in the 1970's and the subsequent decrease thereof in 1978 – the decreased tax rate led to an

¹⁴ Developed by economic Arthur Laffer, the Laffer curve is a graph purporting to show the relationship between tax rates and government income; income increases as tax rates increase, up to an optimum beyond which income declines

explosive release of the capital investments that had been held by investors due to the initial rate increase. The resultant of these investment disposals was a 30% increase in revenues from capital gains tax.

Rahn adds that further changes to the US capital gains tax rates occurred in 1981 (a decrease), 1986 and 1990 (increases) and then again in 1997 and 2003 (both decreases). The difference in fiscal revenue collections from capital gains observed in the high- and low-rate periods was approximately 1000% in favour of the low-rate period – evidence that the tax was avoided via the deferment of sales.

Grubel (2000) quotes the economic theory of optimal taxation, which has developed since 1975, and argues that the economic cost of taxation is higher the more easily the tax can be avoided by those required to pay it. He states that by the standards imposed by that theory, “the capital gains tax is the worst tax of all”, in that taxpayers can avoid paying capital gains tax simply by not realising their capital gains. By reducing savings levels, and investing in assets with low probabilities of increasing values and capital gains, avoidance is far easier than when attempting to perform similar exercises on normal income streams.

Grubel states further that, in principle, a tax regime which contains no taxing statutes for capital gains allows taxpayers to formulate legal opportunities for the evasion of taxes, such as schemes which convert taxable income to non-taxable capital gains. This has important implications for the overall fairness of the taxation system in question. Notwithstanding this, however, he states that the use of the aforementioned opportunities is limited by two factors – the complicated nature of the methods

involved, which are costly for small and wholly owned businesses, and additionally the accounting, market and common law legislation by which larger firms must abide.

Hsu and Yuen (2000) performed a study on tax avoidance due to the lack of capital gains tax in Hong Kong (i.e. avoidance schemes which transformed taxable income into non-taxable capital gains, as discussed above). Their study, described as one providing definitive evidence of conditions in a tax regime free of capital gains tax, concluded that the absence of such a tax has caused few, if any, inequalities and inefficiencies in the Hong Kong fiscal jurisdiction. The authors stated that the major reasons for the lack of negative effects were anti-avoidance provisions preventing “sham” transactions, and preventing transactions with a sole or dominant purpose to avoid taxation – in essence, the same general anti-avoidance provision is found in section 103(1) of the South African legislation.

Ultimately, Hsu and Yuen gathered sufficient empirical evidence to conclude that only small businesses tend to make efforts to avoid normal income taxes by increasing capital gains through excessive reinvestment of profits and low personal compensation of owners – in other words, converting taxable profits into capital gains. They stated that the economic importance of such small businesses is relatively minor in Hong Kong in the context of total fiscal revenue.

Diaz (2000) states that if income and capital gains are taxed differently, taxpayers will “tend to engage in tax arbitrage” and shift income to the lower taxed method. He states that because of this tendency, “... the correct, neutral and equitable goal is not a favoured treatment for capital gains, but rather to strive for a symmetrical treatment of

distributed profits and of capital gains. If the first are taxed twice so should the other and, if the first are not adjusted for inflation, it is not clear why the other should". In other words, introducing a capital gains tax which has a lower effective rate than normal income taxes will not have a noticeable or significant decreasing effect on tax avoidance schemes.

4.8 The Promotion of Taxpayer Equity

Capital gains tax is seen by many as a "wealth tax", affecting only higher income-earning entities. As a result, where a progressive system of direct taxation is sought by a country (i.e. the imposition of higher effective rates on higher-earning taxpayers), a tax on capital gains is seen to be an effective measure of taxing the rich without affecting taxpayers in the lower brackets.

Grubel (1999), however, notes that (at the time of that study) more than half of capital gains taxes were paid by taxpayers earning less than \$50,000 per annum on average. Additionally, the income of those taxpayers appeared much higher in the years in which the capital gains were reported than in previous years of assessment, because of what Grubel described as "the infrequent impact of capital gains realisations".

Krishna (1999) referred to the above as the "bunching effect", and pointed out that this effect often works against the progressiveness of the tax system in question. Krishna used the following example to illustrate this effect: "... if you buy shares in year one for \$20 and sell the shares in year five for \$120, the gain of \$100 reflects the unrealised accrual of gains over five years. The triggering event is the sale of the shares, triggering a realised capital gain. Until that time, the gain is simply accruing and has no consequences for the taxpayer." Krishna concludes that this effect can be inequitable in the case of some taxpayers, particularly those in the lower income

brackets, and the effect in the year in which the gain is reported will often move them into a higher tax bracket, and thus to a higher effective rate of tax.

A study by DRI/McGraw-Hill (1997) noted that the extent to which capital gains tax cuts benefit differing demographics can be analysed via the composition of stock-market investors, pension fund participants and mutual fund holders. United States evidence revealed a much wider spread of investors in terms of gender, race, education levels and income groups than had historically been observed. The authors of the study state that this composition is evidence of the variety of taxpayers that benefit when tax rates on the realisations of their investment assets are lowered, and a counterargument to the taxing of capital gains as a fiscal equity measure.

Wanniski (1995) noted that when a government imposes high taxes on capital gains, the demographic most affected tends to be "...the poorest, the youngest, those at the beginning of their careers, those who are furthest from the sources of capital". Wanniski concluded thus that this demographic group, who have no wealth, but aspire to accumulate it, are those who benefit the most from the decrease or removal from a tax on capital gains.

Sinai (2000) noted that arguments based on the widespread belief that a reduction in capital tax rates favour the rich over the poor may have some legitimacy, although this is mitigated by effects such as the one noted above. Sinai identified the equity issue as an area of significant controversy when deciding what measures need to be taken in respect of capital gains tax legislation, and stated that countries must weigh up fairness issues against all other criteria when making decisions in this regard.

Economic interest group Americans for Tax Reform opine that the capital gains tax is highly inequitable for senior citizens, given that their capital holdings frequently comprise long-term investments which are realised to meet living costs. They quote Blinder (1980) as stating that most capital gains for taxpayers of this demographic group were not real gains at all, but merely the nominal maintenance of the principal investment. In real terms, low-income taxpayers who liquidate long-term capital investments to maintain wealth are subject to capital gains tax at higher effective rates than higher net income, short-term horizon taxpayers. This is due to the fact that the bulk of the capital gain comprises inflation.

The point made above is supported by many critics of the argument that cuts in capital gains taxes benefit the rich. The need for senior citizens and low- to middle-income taxpayers to liquidate their capital investments in order to realise the gains results in far less discretion for those taxpayers than is evident in higher income individuals. As noted elsewhere in this dissertation, wealthy taxpayers are more willing and able to defer the realisation of their capital investment when effective rates of capital gains tax are high. These individuals operate on investment horizons that are far more elastic than other groups, reducing the progressiveness of capital gains tax provisions over a given tax base.

Brenner's (1999) comments regarding capital mobility (referred to above) uphold the above argument. As capital flows away from constraints, including taxing provisions, the level of mobility of capital is crucial to the revenue that will be derived from taxing it. Wealthy taxpayers have far more mobile capital, as they will, in most cases, have the means to move the capital away from high effective tax rates to offshore

jurisdictions or other investments. Lower-income taxpayers have no such ability, and their capital tends to be more immobile and therefore more subject to tax. High rates of capital gains taxes will therefore usually find its tax base in the immobile capital of lower income groups.

Webb (1980) added that as high net worth individuals may have large, diversified portfolios consisting of different classes and categories of assets, while lower income groups (having less wealth to invest) would have more simplistic ones. As diversified portfolios allow investors to hedge risk by offering differing appreciation trends over the asset classes, situations would arise where some assets in the portfolio generate capital gains whilst some would generate losses. The effect may be a net capital gain position that approaches nil, effectively hedging the capital gains tax burden along with the portfolio performance. Conversely, investors with small, simplistic portfolios may not have the opportunity to diversify to any significant extent, decreasing (but not eliminating) the availability of capital losses to offset capital gains in the balance of their portfolios. The capital gains tax environment, would, in this case, favour the wealthy investor and undermine the equity of the tax system as a whole.

5 APPLICATION OF THE INTERNATIONAL OBSERVATIONS TO SOUTH AFRICAN FISCAL POLICY GOALS

5.1 Introduction

The literature review allows the critical analysis of the capital gains tax as an effective fiscal policy tool in the South African context. The observed consequences of capital gains tax in foreign tax jurisdictions will be used as the yardstick for deducing the expected results of the tax in the context of the South African economy. When measuring these expected results against the stated fiscal and economic policy goals, the relative effectiveness of the capital gains tax can be ascertained.

The following fiscal policy goals will be utilised for the critical analysis:

- Sustained economic growth
- Increased productive employment
- Increased competition and the removal of barriers to enterprise creation
- Redistribution of resources to increase overall equity
- Increased productive investment (both domestic and foreign) with associated capital formation
- Enterprise development
- The combating of avoidance schemes that eroded the efficiency of the tax base
- The improvement of the overall equity of the South African tax system

5.1.1 Sustained Economic Growth

As noted in section 2.1.1, economic growth and prosperity cannot be achieved without sustained levels of investment. Fiscal policy which results in an increase of effective rates of tax on capital (and subsequent decrease in the average rate of capital return)

would serve to repel capital rather than attract it, and thus suppress the levels of investment needed to generate and sustain economic growth. This is especially pertinent in an economy such as South Africa's, which has historically been bereft of investment.

Countries which do not allow indexing (as is the case with South Africa) would have a higher effective rate of capital gains tax than countries that do, due to the fact that real returns would be measured at inflation-adjusted levels. The table below, which is sourced from the American Council for Capital Formation¹⁵, shows the average effective rates of capital gains taxes for a sample of global tax jurisdictions.

Table 1: Comparative capital gains tax rates of selected countries

Country	Tax Rate (Corporates)	Tax Rate (Individuals)
Australia	36%	47%
Belgium	40%	55%
Canada	29%	29%
France	21%	33%
Germany	42%	57%
Hong Kong	0%	0%
Italy	37%	46%
Japan	30%	37%
Netherlands	35%	60%
Singapore	0%	0%
South Africa	14.5%	10%
South Korea	28%	40%
Sweden	28%	30%
Taiwan	25%	40%
United Kingdom	30%	40%
United States	35%	18%

In the above comparison, South Africa offers a strongly competitive tax rate on capital gains, and would appear comparatively attractive to foreign investors. The

¹⁵ American Council for Capital Formation, Background material for the SSC on Banking, Trade and Commerce, 16 December 1999

effects of foreign exchange differences and inflation have been ignored for the purposes of the above comparison, assuming the presence of purchasing power parity in the South African context.

Notwithstanding the above, the South African capitals gains tax is a disincentive for foreign investors given that it precludes easy disinvestment and capital mobility. Competitive capital gains tax rates are only effective in a *ceteris paribus* environment. Given that South Africa has historically had a capital gains tax of 0%, the sudden introduction of capital gains tax would have negative short-term effect on direct foreign investment. This is exacerbated in the South African context by the existence of the secondary tax on companies¹⁶, which adds to the disinvestment impediment by limiting the efficiency with which foreign investors can repatriate funds.

5.1.2 Increased Productive Employment

Labour market forces and characteristics differ from country to country, and whilst international researchers have linked the availability of capital to worker productivity, this is not necessarily true for South Africa. It is therefore difficult to apply the specific observations of international commentators to the South African context. Although independent South African studies have revealed a correlation between an increased South African capital/labour ratio and real wage rates during the 1990's (Strydom, 2000 and Mazumdar and van Seventer, 2002), the relationship between capital investment and labour productivity has proven inverse in certain circumstances.

¹⁶ Secondary tax on companies ("STC") is levied at 12,5% on the net amount of dividends paid by South African companies. The tax is "secondary" as distributions are made from income which has already been subject to normal companies tax. Distributions to shareholders therefore result in higher effective tax rates for the paying entity, which reduces the level of earnings available for distribution.

However, a principle that can be considered universal is that the growth of productive labour levels cannot be considered independently of other economic areas. The achievement of the economic goals considered elsewhere in this section has a direct impact of the achievement of the goal of job creation.

John F. Kennedy, when discussing the United States economy, stated that "...a rising tide lifts all boats". This statement applies to the South African job market - investment and capital formation lead to business creation and economic growth, which leads to an increased demand for labour, both skilled and unskilled. The South African government's fiscal policy goal of increased investment is therefore directly correlated to its goal of increased productive employment.

As discussed above, the capital gains tax is a proven depressant of investment and thereby economic growth – logically, it must also serve as a debilitating factor in the growth of the South African labour market. Decreased investment in high-growth or start-up companies affects the demand for labour (due to less expansion), while the lack of direct investment and growth in areas such as construction and infrastructure affect the demand for unskilled labour (the largest component of unemployed South Africans).

The relationship between investment, economic growth and job creation is well-documented. It is therefore incongruous for a capital gains tax to be introduced in a country such as South Africa, where economic growth and job creation are major priorities. Furthermore, although the fiscal goal of equity is discussed in more detail in

a subsequent section, it is noted that fiscal measures which affect the employment levels of unskilled labourers are counterproductive to the goal of equity.

5.1.3 Increased Competition and Enterprise Development

As indicated in section 2.1.5, capital gains tax may result in a decrease in private equity funding – a crucial component of enterprise development. Research by KPMG on the growth of the South African venture capital market indicates growth of 16,6% from 2001 to 2004, as opposed to 20,5% in the preceding four-year period (KPMG and South African Venture Capital Association, 2004). Although this slowdown in growth cannot be solely attributed to the introduction of a tax on capital gains, the global research in this area confirms that this is a possible factor thereof.

The depressive effect on financial markets noted by Sinai is relevant in the South African context – although the factors influencing the South African stock market are numerous, a tax on capital gains has the proven depressive effect. The stock market attracts foreign investment in local domestic companies. Furthermore, the exempt dividend aspect of South African tax, coupled with the preceding effect, skews investor tendencies away from stocks which have historically high capital growth towards stocks with guaranteed dividend yields.

Not only does this affect growth firms, but also alters investment activities – shareholders are incentivised to hold equity assets to realise the benefit of exempt dividend income and avoid tax on the disposal thereof. This creates distortions in the overall investment activities of the South African financial market participants. Furthermore, this phenomenon tends to draw productive investment away from high-

growth stocks (such as start-up and technological businesses) in favour of more established companies that pay regular dividends.

It is submitted, however, that the focus of this particular fiscal goal is not established, listed entities but rather small- to medium-sized enterprises. While the Income Tax Act contains provisions for tax breaks for these enterprises, growth is discouraged via the taxation of the capital providing their funding as well as limiting the extent to which internally generated capital can be mobilised and invested.

Small and medium start-up businesses in most cases receive the bulk of their equity financing from non-institutional investors. This is supported by the composition of the South African venture capital market presented below. The negative effects on venture capital noted in the global literature would therefore find a domestic application, based on the similarities in market compositions. The decrease in domestic equity financing would result in decreased enterprise creation.

Increased costs of capital and decreased returns are a proven concomitant of taxing capital gains. These effects, when coupled with a decreased acceleration of venture capital availability, form a severely depressive barrier to business creation and enterprise development.

5.1.4 Increased Productive Investment with Associated Capital Formation

Taxes on capital encourage debt financing rather than the use of equity. This is due to the discouragement of private equity investors who require certain rates of return on

capital – rates which are not achieved when the capital is ultimately taxed on liquidation.

The scenario above is not limited to the philosophies of private investors – the cost of capital of a company is measured by weighting the debt and equity components, resulting in a figure known as a weighted average cost of capital (or WACC). Most corporate stakeholders require a WACC equal to their long-term rate of return, and will raise additional finance through cheaper debt if the cost of equity capital rises (i.e. via a tax on capital gains). This approach serves to reduce the opportunities for productive investment by private equity investors, who will now achieve their returns through lending rather than investment in equity shareholdings.

The situation is exacerbated by the South African secondary tax on companies (STC), which taxes the dividend flows earned by private investors. Although the taxing occurs at the corporate level, and the local dividend receipts are tax-exempt in the hands of the individuals, STC results in decreased cash flows to investors. Coupled with the capital gains tax on disinvestment, the investor is dissuaded from equity investment and will turn to stable products (such as interest-bearing lending) which carry no capital gains cost at termination, as this will protect their principal. The lack of a capital gains tax in a debt situation may well be greater than the cost of the taxable interest income received during the holding period.

The taxing of the terminating cash flow of an investment is a severe issue in its own right. The net present value (NPV) of an investment, as well as the internal rate of return (IRR) measurements are the most common methods used by private investors

to choose where to invest their capital. The terminating cash flow in the final period of the investment will usually include the cash flow from disinvestment, and a tax on that cash flow may reduce the NPV or IRR to a point where the investment is not desirable. This effect also affects the valuation of investments such as property, where the valuation uses discounted cash flows which include the disinvestment transaction.

The global studies reviewed indicated that dissuasion to private investors as a result of a capital gains tax is most prevalent where the composition of a country's private investors comprises sources that are subject to the tax, as opposed to sources such as the untaxed fund of a long-term life assurer. This is the case in South Africa, where companies and individuals form the largest portion of the private investment pool (around 57%), as illustrated in Figure 1 below.

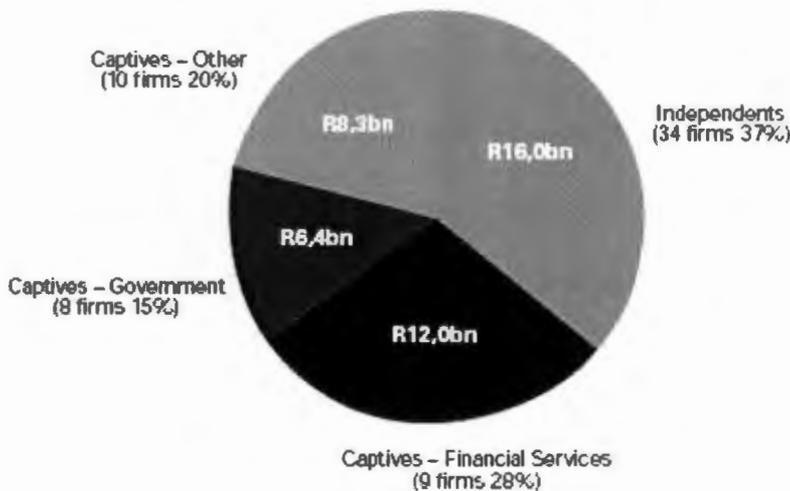


Figure 1: Composition of South African venture capital investors (Source: 2004 KPMG survey on the South African venture capital market)

In a South African study, De Wet and Kock (2004), using statistical techniques, achieved results that supported evidence from Chirinko, Fazzari and Meyer (1999) that corporate taxes play a significant role in the price determination of corporate

capital. The research indicated that taxes which were seen as “additional” to normal profit taxes changed investor behaviour and had a direct effect on the costs of capital for the companies in question.

Another aspect of private investment that is unique to the South African context is the issue of Black Economic Empowerment (BEE) investment. With the movement towards black ownership, private equity investment will be concentrated in this area in the foreseeable future. The investment is achieved in many cases via the disposal of shareholdings in South African companies to BEE investment firms. This carries an additional capital gains tax burden to the selling parties as well as the investment firms themselves. The effect of this increased burden is a decreased availability of capital for other areas of investment.

Mintz’s comments in respect of the double-taxation of savings are also particularly relevant in the South African context, where increased consumption may fuel inflation.

Spindler’s comments that a growth-orientated government should attempt to encourage savings and investment rather than consumption highlight the disparity between the documented effects of capital gains tax in this area and the Department of Finance’s stated goals.

Based on the factors discussed above in conjunction with the global evidence in this area, it seems clear that productive domestic investment would not be encouraged by the continued existence of a tax on capital gains.

5.1.5 To Combat Avoidance Schemes that Eroded the Efficiency of the Tax Base

The overall consensus of the global literature was that the introduction or increase of a capital gains tax as a method of combating tax avoidance is highly ineffective. Capital gains tax is the simplest to avoid, via deferral of the sale. This is contrary to comments made by SARS in their documentation issued at the inception of the capital gains tax in 2001, which stated that the taxing of capital gains, while not totally eliminating avoidance through capitalisation, would discourage it.

Although income tax could be avoided via schemes that capitalised and deferred income streams, the introduction of the South African capital gains tax would not (based on the global literature) significantly deter taxpayers from these schemes. Because of exemptions, exclusions (such as the primary residence exclusion) and the 50% and 25% inclusion rates, capital gains are still more attractive to taxpayers than income. If it is possible for taxpayers to legally alter the nature of their receipts to capital, they will still attempt this under the capital gains tax regime.

Additionally, Goodman's comments regarding the limited opportunities for taxpayers to initiate avoidance schemes are valid in the South African context. The legal principles and case law precedent outlining the capital or revenue nature of an asset are well-developed, and current-day receipts or expenditure are unlikely to traverse those categories unless a valid change of intention occurs. The result of this is that only valid tax avoidance schemes utilising legal means would employ a capitalisation method, and will continue to do so whether capital gains are taxed or not.

SARS' argument that capital gains tax would combat tax avoidance schemes is also undermined by the economic theory underlying the Laffer curve. As the new tax increased marginal tax rates, according to the curve taxpayers would now have an increased propensity to avoid taxation, as well as a simple method to do so (by simply not disposing of an asset).

The South African general anti-avoidance provision found in the Income Tax Act operates on the same basis as many of the countries discussed in the literature – transactions must have a commercial purpose, and must have an obvious element of normality and arms-length transacting between parties.

Lastly, the discussions on the revenue generating effects of the capital gains tax conclude that no country has seen a major increase in revenue collection from such a tax. Conversely, due to the multitude of negative economic effects (such as employment and production), normal income tax collection is often reduced.

The South African Treasury does not report tax collections on capital gains. Collections from personal and corporate income tax are, however, provided. The distinction of what comprises capital gains tax is not made. Access to the capital gains tax collection data for the purpose of this study was refused by the National Treasury. It is therefore not possible to quantify the effect of the capital gains tax on government revenues. A review of the Medium Term Budget Policy Statements for the 2000 to 2004 fiscal years revealed no commentary from the government on the revenue-generating abilities of the capital gains tax. Increases in revenues were justified by such phenomena as wage negotiations, increased dividend payouts (generating high

levels of secondary tax on companies) and price increases (for value-added tax). No mention of capital gains tax as a revenue booster has been made in the four years subsequent to its introduction. Furthermore, no such growth was budgeted for in either the 2001 or 2002 fiscal years. Given the relative silence of the South African government on its efficacy, coupled with the nature of the tax as a “voluntary” one (i.e. it can be avoided by deferring the disposals of assets), it is impossible to speculate on capital gains tax revenue collections and their growth over time.

5.1.6 To Improve the Overall Equity of the South African Tax System

Numerous documents issued by government have cited measures to improve the equity of the South African tax system (*inter alia* presentations by Trevor Manuel 1996 and 1997 referenced supra, and Policy Briefing by the National Treasury, 2001). This is understood to mean the progressiveness of the tax system will be ensured.

Grubel’s measures of the percentage of low-income taxpayers with capital gains have not been performed for the South African context. However, the “bunching” effect described in section 2.1.9 may be relevant to South African taxpayers, given the inclusion method of capital gains in the income tax computation.

Despite the 25% inclusion rates for capital gains, low-income individuals in South Africa may still be elevated into higher tax brackets as a result of a reported capital gain. Measures have been included in the Eighth Schedule to the Income Tax Act as a means of mitigating this, including the primary residence exclusion, annual exclusion and exemption for “personal use assets” (assets which have not been used by the taxpayer in the course of their trade, such as motor vehicles). These measures will

serve to exclude the casual disposal activities of most taxpayers, but do not serve to eliminate the bunching problem. As noted by Krishna (1997), this situation is essentially a higher effective tax rate due to the deferment of accrual.

The counterargument given by SARS against the bunching problem was that all income streams include an inflationary element, and that deferring the taxation of the capital gain mitigated the bunching problem (quoted in the SARS briefing as the results of unidentified “international studies”). While this is true, there is a major flaw in the counterargument. Normal income streams usually adjust to include the year-on-year inflation increases (via wage increases, interest rate changes, and rental escalations). The bunching problem is not inflationary, but a timing difference that causes a large payment of tax in a single period. These large payments are highly inequitable for lower-income taxpayers.

The bunching effect is exacerbated in South Africa by the disallowance of capital losses against normal income. This aspect of the capital gains tax system adds to the globally reported problem of inequity due to the ability of high-income investors to diversify away capital gains tax. Low-income taxpayers, who have limited investments, may only realise the tax benefits of capital losses when a capital gain is realised.

Another globally observed inequitable aspect of the capital gains tax is the effect on senior citizens – when capital assets are realised to meet living costs, the effect described above serves to deplete the principal. This is especially relevant in the South African context, given the historically high inflation rate and lack of indexing.

The drawbacks of inflation indexing have been set out as justification for not introducing such as an aspect of the South African capital gains tax. Reasons given were investment distortion (that indexation would encourage investors into equity investments financed by debt), equity (taxing real capital gains prejudice income-stream investors, who are taxed nominally), the administrative burden, and the lack of reliable indices. While these drawbacks are undeniable, the inequity of the lack of inflation indexation was not, and has not been adequately addressed. The inequity is caused by a combination of bunching and inflationary gains – while these aspects were considered individually, the aggregate effect was not addressed.

The above reasoning, particularly the benefits of deferral, ignore the fact that low- to middle-income individuals, senior citizens and other such demographics are unable to defer gains or diversify. Individuals with limited investing capabilities, or who realise capital investments in order to finance living costs, are subject to an additional tax that increases their effective tax rate. It is submitted that capital gains tax is highly questionable in terms of its equity improvement effects.

5.1.7 Redistribution of Resources to Increase Overall Equity

The South African government has repeatedly emphasised that one of the major goals of the South African fiscal policy is the correction of a historically inequitable distribution of national resources. To achieve this fiscal policy goal it is essential that other goals considered in this section, such as capital formation, the availability of venture capital, labour productivity and increased government revenue are achieved.

Fletcher's comments (Fletcher, 1993), as presented earlier, have a notable impact in the South African context. Due to the historical misallocation of capital resources

caused by apartheid, capital inflows to impoverished rural and urban areas are crucial for economic growth. Coincident to these inflows would be an increase in black-owned businesses. Should capital gains tax be proved to reduce capital investment in these areas, it cannot be considered to be a measure that will aid in the growth of the South African economy.

Since high-income taxpayers are able to defer the payment of capital gains tax via investment holding strategies, or achieve the setoff of capital gains and losses via portfolio diversification, it does not follow that the introduction of capital gains tax would generate significantly increased tax revenues which would be directly reinvested in the areas under consideration.

Finally, the proven depressive effects on enterprise development, capital formation and real wage rates discussed earlier are not consistent with the expected results of a fiscal policy measure intended to reallocate resources equitably. The redistributive functions performed by government should be accompanied by wealth creation in the hands of the individual. As evidenced above, and as noted in the global research reviewed, wealth creation is not maximised in a fiscal structure which taxes capital gains.

6 CONCLUSION

The literature reviewed reflects a number of negative economic and fiscal effects of capital gains tax. The effects which were considered most pertinent to the South African context, in that they relate directly to the long-term economic and fiscal policy goals of the South African government, were focussed on for the purposes of creating a critical framework within which the effectiveness of capital gains tax as a South African fiscal policy tool.

The tax on capital gains was observed to increase relative costs of capital, and decrease the ability of foreign investors to efficiently disinvest from the country imposing such a tax. These effects result in the discouragement of foreign investment, which is a critical component of economic growth. Given the continuing South African policy goal of sustained economic growth, it is submitted that the introduction of the capital gains tax would result in long-term effects that are counterproductive to the achievement of this goal.

Various sources quoted in the literature review cited the negative effects of capital gains tax on job creation. Additionally, the relationship between the availability of capital inputs and the level of productive labour was emphasised – decreases in the level of capital utilised for production effectively decreases worker productivity, and lowers the real wage rate. South Africa has exhibited consistently high levels of unemployment, and the goal of increased productive labour has, as with economic growth, been a key focus of South African economic policy for an extended period of time. The capital gains tax could hamper the achievement of this goal.

The global research indicated that the taxing of capital gains decreased the levels of private equity financing, particularly venture capital, available for investments in private enterprises and entrepreneurial activity, due to increased costs of capital and subsequent dilution of the rates of return required by these investors. This phenomenon is particularly prevalent where the sources of private equity finance are largely made up of entities subject to the higher effective rates of capital gains tax. As with many global examples, the South African private equity market was found to be comprised of individuals and companies (who bear the higher effective capital gains tax rates) to the extent of nearly 60% of available investment. Along with the current focus of private equity investment on black economic empowerment transactions, the capital gains tax will, in the long term, decrease the levels of productive investment available in the South African capital markets.

Additionally, the effects of capital gains on savings and investments indicated that taxpayers are encouraged to consume in the short-term rather than defer consumption via savings and investment. This adds to the problem of decreased productive investment by the casual investor. The abovementioned “drying up” of venture capital, combined with the discouragement of casual private investment undermines the stated policy goal of increased productive investment and capital formation.

Furthermore, the lack of venture capital was noted to have detrimental effects on enterprise development. Depressive effects on stock markets (a major source of new equity finance for established companies) resulting from increases in capital gains tax rates were also noted by foreign researchers. This effect was noted to be exacerbated in the South African context by the tax exemption on dividend income – when

combined with a tax on capital gains, this exemption would skew investor tendencies, leading them to invest in high-yield, rather than high-growth stocks. The aggregate effect of the factors noted is a decrease in the growth potential for small- to medium-sized enterprises, and an overall decrease in entrepreneurial activity. The increased costs of capital and decreased rates of return to entrepreneurs supplement this effect. The South African policy goal of increased enterprise development, and concomitant increases in competition are therefore negatively affected.

As noted in Chapter 4, the consensus of the global studies on capital gains tax was that the introduction of the tax as a method of combating tax avoidance schemes is highly ineffective. Capital gains tax, being triggered by the divestment of assets, is the easiest tax to avoid (simply by deferring the sale). In tax jurisdictions such as South Africa, which contain general and specific anti-avoidance provisions, the possibility of taxpayers avoiding taxation in a commercially abnormal manner is minimised. Notwithstanding this, the economic theory underlying the Laffer curve indicates that an increase in effective tax rates (as with the introduction of capital gains tax) would increase a taxpayer's propensity to avoid the payment of tax.

In addition to the above, the existence of differing inclusion rates for income and capital gains in the South African tax system does not decrease the opportunities for taxpayers to "arbitrage" across types of wealth for tax purposes. This point was noted by the South African Revenue Service in documentation issued at the inception of the tax. When coupled with the observation of a lack of significant growth in government revenue from the introduction of a tax of capital gains, or increases in the effective rates thereof, it is submitted that the dual goals of decreased erosion of the South

African tax base and increased efficiency of the overall tax system will not be achieved via the utilisation of capital gains tax as a fiscal tool in this regard.

Lastly, a variety of counterarguments to the point that capital gains tax is a “wealth tax” that increases the progressiveness of a country’s tax system was imparted from the global commentary. In conjunction with the redistribution of resources, the primary goal of the introduction of a South African tax on capital gains was an increase in the overall equity of the South African tax system. It was thought the capital transactions which would give rise to the highest levels of government revenue would be undertaken by higher-income taxpayers, thus increasing the progressiveness of the tax system and allowing the government to reinvest a portion of the wealth of those taxpayers into areas benefiting the poor.

The “bunching” problem, discussed in detail in Chapters 2 and 4 of this study, was noted by the South African Revenue Service as a possible downside in respect of the promotion of taxpayer equity. To this end, certain exclusions and relief provisions were introduced in the capital gains tax legislation, in order to provide relief for casual disposal transactions such as the selling of primary residences and personal use assets. The annual exclusion of R10 000 and 50% and 25% inclusion rates also provided relief to taxpayers in this regard. Notwithstanding these measures, the bunching effect was not totally mitigated. Deferred accruals of income via capital investments will still be taxed at a higher effective rate, due to the elevation of a taxpayer’s taxable income into higher tax brackets. As noted in Chapter 4 of this study, the disallowance of capital losses against normal income also adds to the bunching effect.

Other arguments against the promotion of taxpayer equity via the use of a capital gains tax included the effect on senior citizens and other long-term lower income investors, who lose portions of their principal investments due to the lack of inflation indexing in the South African capital gains tax legislation. This effect is more prevalent in lower- and middle-income groups, as high-income taxpayers usually have more diversified investment portfolios. Such portfolios generate capital losses to set off against capital gains, and decrease the effective tax rates for these wealthy taxpayers.

When taken into account, the abovementioned factors (along with knock-on effects from the other negative aspects of capital gains tax as discussed above) serve to run contrary to the stated fiscal goal of improved taxpayer equity and resource allocation.

The introduction of the tax on capital gains in South Africa will not assist the South African government in the achieving of its significant fiscal and economic policy goals. The high degree of similarity between the economic conditions specified in the international research and those in the South African context serve as conclusive proof that the negative effects of the capital gains tax will, in the long term, be observed in the domestic context.

The negative economic and fiscal effects mentioned above would, without exception, serve as countermeasures to the overall achievement of the economic goals discussed above.

Despite counterarguments presented by the South African Revenue Service to certain of the observations presented above, from international experience the long-term effects of the capital gains tax may be wholly incongruent with the intended effects thereof. The outcome of the critical analysis in this study leads to the recommendation that the introduction of such a tax in the domestic context was premature and incomplete, as certain provisions (such as indexation and revised capital loss legislation) may have mitigated the aforementioned ineffectiveness, and improved the overall quality of the tax as a fiscal policy measure.

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