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An Economic Appraisal of Arguments For and Against South Africa's Proposed Capital Gains Tax Legislation

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ABSTRACT

An Economic Appraisal of Arguments For and Against South Africa's Proposed Capital Gains Tax Legislation

This submission summarises research by the Economic Policy Research Institute concerning the proposed tax on capital gains. The report appraises arguments for and against the proposed law. On balance, the research supports the implementation of the capital gains tax (CGT) as proposed by the National Treasury.

ARGUMENTS PRESENTED FOR THE PROPOSED LAW

(1) The CGT will reduce distortions in the tax system.

CRITIQUE: The absence of a capital gains tax creates significant distortions in South Africa's tax structure, leading to an erosion of the tax base and wasted resources that could otherwise promote economic growth and job creation. The proposed legislation will provide some measure of correction to these distortions, but will not eliminate them completely because only a fraction of the capital gains are subject to tax.

(2) The CGT will provide a more equitable tax structure.

CRITIQUE: A rand earned through the sale of a capital asset bestows the same economic power as does a rand gained through employment, and principles of horizontal equity suggest they should be taxed similarly. Furthermore, high net worth individuals benefit from a disproportionate share of capital gains, so the absence of a CGT skews the burden of taxation onto lower income individuals. The proposed legislation will move towards a more equitable tax structure. However, since only a proportion of capital gains are subject to tax, those fortunate enough to enjoy capital gains will continue to benefit from preferential tax treatment.

ARGUMENTS PRESENTED AGAINST THE PROPOSED LAW

(1) The CGT will not provide significant tax revenue.

CRITIQUE: Evidence that the capital gains tax will not provide a significant source of revenue is subject to substantial critique. Estimates from cross-country comparisons are of limited value because of substantial differences between South Africa's current circumstances and the context of these studies. First, elements of the proposed capital gains tax law effectively close loopholes that undermined revenue gains in the comparison countries. Second, since the proposed legislation reduces the incentives for converting other income into capital gains, the tax revenue resulting from the new law will be greater than the directly measured tax on capital gains. The resulting tax revenue will include not only capital gains taxes but also incremental taxes on the broadened tax base, revenue that was not calculated in the comparison studies. Also, the significant increases in income from capital gains over the past few years make older studies less reliable.

(2) The CGT will undermine investment and economic growth.
CRITIQUE: Economic evidence concerning the impact of a capital gains tax on investment and growth is ambiguous. Numerous studies contradict the notion that a capital gains tax undermines incentives for savings and investment.

(3) There is not sufficient time for implementation on April 1.
CRITIQUE: The National Treasury has provided more time for preparation for the new tax than is frequently provided in other countries. Even with implementation on 1 April 2001, individuals and companies have had more than a year to deal with the consequences of the proposed legislation. Arguments exist for some delay in the implementation date, but the frequently articulated argument for a one-year extension is difficult to substantiate.

(4) Indexation of capital gains complicates the tax system.
CRITIQUE: This is a valid argument in South Africa's context. However, the notion that indexation complicates the tax system presumes that indexation is a necessary aspect of a capital gains tax. Most countries with a capital gains tax do not adjust capital gains for inflation, and some of those who do are moving away from this practice. Furthermore, indexation undermines the efficiency and equity of the tax structure.

(5) A capital gains tax "locks" taxpayers into investments.
CRITIQUE: A capital gains tax does tend to undermine the free movement of capital by creating incentives to hold onto appreciating investments. However, this same principle also tends to foster a choice towards savings rather than consumption, which can promote economic growth and job creation.

(6) The CGT will undermine our international competitiveness.
CRITIQUE: The capital gains tax is a generally accepted form of taxation in nearly all industrialised countries. The proposed effective tax rates are substantially lower than international norms. Furthermore, by promoting equity and financing social development, the capital gains tax can foster improved labour and capital productivity that enhances South Africa's international competitiveness.

Conclusion

On balance, the proposed legislation evenly weighs the advantages and disadvantages of the capital gains tax and arrives at a policy reform that improves South Africa's tax structure and economic prospects. Given the politically volatile nature of the reform, many people will undoubtedly find fault will many aspects of the legislation. Nevertheless, the proposed tax is well crafted to achieve important policy objectives furthering social equity, economic growth and job creation.

TABLE OF CONTENTS

TABLE OF FIGURES

INTRODUCTION

This submission summarises research by the Economic Policy Research Institute concerning the proposed tax on capital gains. The report critically appraises arguments for and against the proposed law. On balance, the research supports the implementation of the capital gains tax (CGT) as proposed by the National Treasury. The following discussion analyses each of the arguments in further detail.

ARGUMENTS PRESENTED FOR THE PROPOSED LAW

(1) The tax will reduce distortions in the tax system.

The South African Revenue Service supports the proposed law by arguing that "the absence of a CGT creates many distortions in the economy, by encouraging taxpayers to convert otherwise taxable income into tax-free capital gains. The South African Revenue Service has observed that sophisticated taxpayers have engaged in these conversion transactions, thereby eroding the corporate and individual income tax bases. This erosion reduces the efficiency and equity of the overall tax system. A CGT is, therefore, a critical element of any income tax system as it protects the integrity of the personal and corporate income tax bases and can materially assist in improving tax morality."[1]

This reasoning provides one of the strongest arguments for the CGT. The artificial conversion of income to capital gains not only erodes the tax base, but it also absorbs productive economic resources that could be more efficiently employed in raising real economic growth. Nevertheless, the proposed tax law only partially reduces the incentives to convert income to capital gains, because it only taxes a portion of the capital gains. For natural persons, only 25% of the capital gains are subject to tax, while for legal persons, only 50% of the capital gains are subject to tax. Therefo substantial distortions in the tax system will remain. Nevertheless, the proposed tax law significantly reduces the incentive for efficiency-distorting income conversion.

(2) The tax will provide a more equitable tax structure.

Internationally, tax jurisprudence recognises the importance of taxing capital gains in order to treat different sources of income equitably.[2] Likewise, the Katz Commission has recognised the importance of a capital gains tax not only for actually improving equity but also for supporting the perception of fairness.[3] Capital gains accrue primarily to the wealthy, who by definition are the primary holders of assets that yield capital gains. In the United States, the Deputy Assistant Secretary for Tax Analysis at the U.S. Department of the Treasury has quantified the skewed accumulation of capital gains to the wealthy. Leonard Burman employs a ten-year panel data set (1979 to 1988), demonstrating that the 3% of taxpayers whose real incomes (in 1993 dollars) exceed $100,000 received nearly three-quarters of the capital gains. A more recent cross-section of a single year's tax returns reveals about the same degree of concentration.[4] Given South Africa's substantially more skewed distribution of income and wealth, it is

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[1] South African Revenue Service, 2000. "Guide to the Capital Gains Tax". Pretoria: National Treasury, 23 February 2000.

[2] The SARS "Guide to the Capital Gains Tax" quotes the Canadian Carter Commission, "A dollar gained through the sale of a share, bond or piece of real property bestows exactly the same economic power as a dollar gained through employment or operating a business." Likewise, it raises the argument made for implementing the CGT in the United Kingdom: "The failure to tax capital gains is widely regarded…as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage earner."

[3] The Katz Commission report (op. cit.) states: "In so far as the absence of taxation of significant resources of income concentrated in the hands of the rich is perceived as unfair, the introduction of an effective capital gains tax might be beneficial to taxpayer morale and ethics." (Page 46)

[4] Leonard E. Burman, 1999. *The labyrinth of capital gains tax policy: A guide for the perplexed.* Washington, D.C.: Brookings Institution Press. See also: "Review of *The labyrinth of capital gains tax policy"* by Joel Slemrod (Reviewer). *Journal of Economic Literature*, 38(3), September 2000, pages 657-659.

possible that the incidence of capital gains in South Africa is even more concentrated in the hands of the wealthy.[5]

While taxing capital gains will improve the equity associated with South Africa's tax structure, the fact that only a portion of capital gains are subject to tax undermines the horizontal and vertical equity of the tax structure. Furthermore, capital gains benefit from a much higher exclusion than either interest or dividends.

ARGUMENTS PRESENTED AGAINST THE PROPOSED LAW

(1) The tax will not provide significant revenue.

Critics of the capital gains tax have suggested that the proposed tax will not provide significant revenue. The Katz Commission suggests that revenue from a capital gains tax in South Africa might not be great enough to offset added administrative costs.[6] Part of the basis for this stems from dated international studies that document a relatively low contribution to overall revenue from capital gains taxes.[7] The applicability of these studies to South Africa's situation is limited.

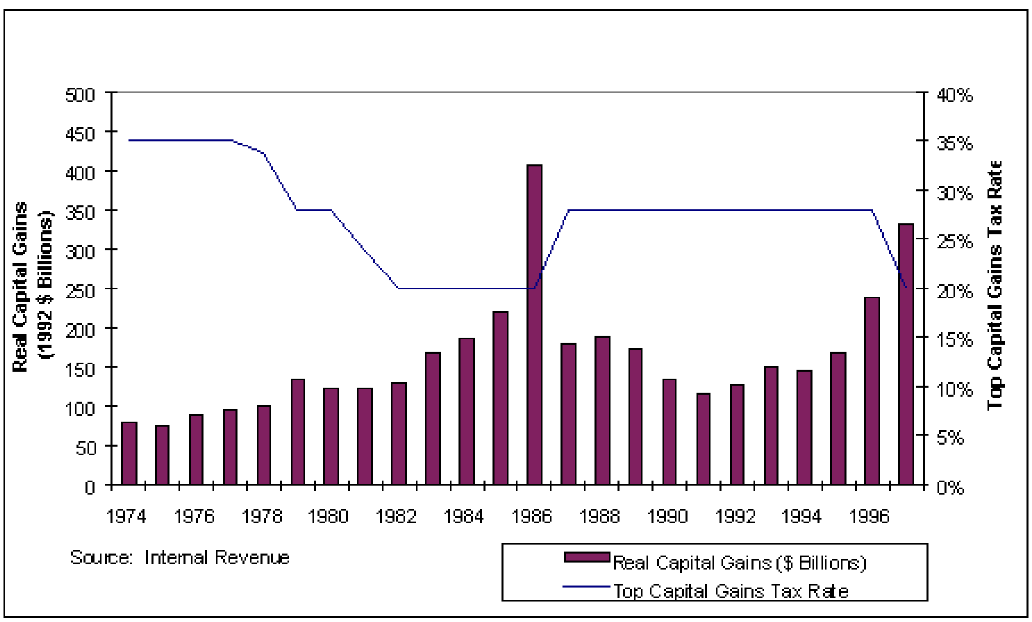
The actual revenue increase that South Africa will realise may be higher for several reasons. First, the amount of revenue measured by these studies is the direct collection of taxes on capital gains. This is only part of the revenue improvement. Because a CGT reduces the incentive to convert other sources of income into tax-favoured capital gains, much of the improvement in tax collection accrues through a broadened tax base above and beyond capital gains. Second, the proposed legislation

[5] According to the United States Census Bureau, the Gini coefficient measuring inequality in the United States was 0.46 in 1996, while the measure is substantially higher in South Africa. The *Poverty and Inequality Report* indicates a Gini coefficient for South Africa of 0.58, documenting one of the world's most unequal distributions of income and wealth. (Poverty and Inequality in South Africa, Report prepared for the Office of the Executive Deputy President and the Inter-Ministerial Committee for Poverty and Inequality, Summary Report, 13 May 1998, Editor and Project Leader: Julian May.)

[6] M.M. Katz et al. 1995. "Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa." Pretoria: Republic of South Africa.

allows for constructive realisation of the capital gains on the death of the asset hold This provision prevents the capital gains basis from being stepped up with the resulting tax revenue loss. Third, the broadened expansion of equity ownership and rising valuations have dramatically raised the value of capital gains over the past several years, limiting the usefulness of studies more than a few years old. For instance, in the United States, the ratio of net capital gains in adjusted gross income to total adjusted gross income doubled from 3.6% in 1990 to 7.3% in 1997.[8] The volatility of capital gains and the recent upward trend is documented in the graph on the next page.[9] This demonstrates the degree to which earlier studies underestimate current potential for capital gains taxation, as well as the complexity of predicting revenue from a capital gains tax.

CAPITAL GAINS TAX REVENUE IN THE UNITED STATES (1974-1997)



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[7] For instance, the Katz Commission relies on two studies, one for the United States in 1987 and one for the United Kingdom in 1992.

[8] Leonard E. Burman, 1999. *The labyrinth of capital gains tax policy: A guide for the perplexed.* Washington, D.C.: Brookings Institution Press. See also: "Review of *The labyrinth of capital gains tax policy"* by Joel Slemrod (Reviewer). *Journal of Economic Literature*, 38(3), September 2000, pages 657-659.

(2) The tax will undermine investment and economic growth.

A major South African law firm raises a critical question embroiled in the debate around the capital gains tax: "What is the effect of CGT, Inflation and STC going to do to investor confidence in the new South Africa?"[10] The conventional wisdom can be summarised: "An oft-stated dictum of journalists and politicians is that [preferential treatment for capital gains] will increase economic growth by encouraging investment in new firms."[11] For instance, a proponent of preferential treatment for capital gains claims that "because the [capital gains] tax restricts capital formation, its burden falls on new business start-ups."[12]

A large body of theoretical and empirical evidence, however, questions this conventional wisdom. While Chief Economist of the World Bank, Joseph Stiglitz argued: "In the United States, preferential treatment of capital gains has been defended on the grounds that it encourages risk taking and entrepreneurship, of the kind associated with the knowledge economy. But most of the tax preferences go not to this kind of entrepreneurship, but, for instance, to speculative real estate lending. I referred earlier to the importance of a change in culture. A tax system that rewards the returns to speculative real estate in the same way that it rewards real innovation is not supporting the culture of innovation."[13] His arguments are rooted not only in empirical observations

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[9]United States Senate Joint Economic Committee, 1999. "Cutting Capital Gains Tax Rates" (Joint Economic Committee Staff Report). Washington, D.C. August 1999. Internet address: http://www.senate.gov/~jec/capgains.htm

[10] Cliffe Dekker Fuller Moore Inc., 2000. "Capital Gains Tax". Web-page article at internet address: http://www.cliffedekker.co.za/pubs/matters-CGT-1.htm

[11] M. Kevin McGee, 1998. "Capital Gains Taxation and New Firm Investment". National Tax Journal Vol. LI (1998), No. 4.

[12] W. Kurt Hauser, 1995. "Capital Gains: Lift the Burden" Wall Street Journal (October 24, 1995), Page A22. (Cited by M. Kevin McGee, 1998. "Capital Gains Taxation and New Firm Investment". National Tax Journal Vol. LI (1998), No. 4.)

[13] Joseph Stiglitz, 1999. "Public Policy for a Knowledge Economy" (Remarks at the Department for Trade and Industry and Center for Economic Policy Research by Joseph Stiglitz, Senior Vice President and Chief Economist, The World Bank Group). London, January 27, 1999.

of the American economy but also theoretical modeling that calls into question t[...] desirability of employing preferential treatment of capital gains to promote risk-taking.[14]

The Deputy Assistant Secretary for Tax Analysis at the U.S. Department of the Treasury, Leonard Burman, concludes that the preferential treatment of capital gains undermines economic growth.[15] Numerous theoretical and empirical studies corroborate this finding. A recent theoretical development of a supply side model demonstrates significant positive growth effects stemming from capital taxes.[16] Another study that focused on fiscal constraints similar to those South Africa faces concluded that increases in capital taxes reduced interest rates and raised capital investment.[17] A study analysing open economy characteristics and trade deficits found that increases in capital taxation might increase wages and social welfare.[18] A simulation model built to distinguish the differential impact of capital gains taxation on new and established firms demonstrates that beneficial treatment of capital gains can actually reduce new firm investment. The study "contradicts the widely held view that a capital gains tax cut would be a well-targeted approach for encouraging new firm capital formation."[19]

(3) There is not sufficient time for implementation on April 1.

Many critics of the current legislation question the feasibility of implementing the proposed legislation before the indicated deadline, with many calling for a one-year

[14] Joseph Stiglitz, 1969. "The Effects of Income, Wealth, and Capital Gains Taxation on Risk-Taking" in the *Quarterly Journal of Economics*, 83(2), May 1969, pages 263-83.
[15] Leonard E. Burman, 1999. *The labyrinth of capital gains tax policy: A guide for the perplexed.* Washington, D.C.: Brookings Institution Press. See also: "Review of *The labyrinth of capital gains tax policy"* by Joel Slemrod (Reviewer). *Journal of Economic Literature*, 38(3), September 2000, pages 657-659.
[16] Hans Peter Gruener and Burkhard Heer, 1996. " Should Capital Be Taxed?" Universitat Bonn Sonderforschungsbereich 303 Discussion Paper A522, May 1996.
[17]Shuanglin Lin, 1994. "Capital Taxation and Accumulation in a Growing World Economy with Deficit Finance". *International Tax and Public Finance*, 1(2), October 1994.
[18] Anne Sibert, 1988. "Taxing Capital in an Open Economy". Federal Reserve Bank of Kansas City Research Working Paper 88-11, December 1988. Also, "Taxing Capital in a Large, Open Economy" in *Journal of Public Economics*, 41(3), April 1990, pages 297-317.

delay. A major South African law firm raises the question: "Won't implementation be delayed?" and answers it: “Not likely! Remember, SARS only has to get the legislation through parliament by April 2001. Thereafter SARS has a period of approximately 18 months to get ready to process the first tax returns affected by CGT. Taxpayers need to plan now!”[20] The National Treasury provided substantially more notice for this proposed legislation than is frequently available internationally when changes to capital gains taxation are implemented. South African companies have demonstrated a strong technical capacity to deal with substantial changes to financial systems--the success last year in dealing with Y2K provides a good example. EPRI’s research finds no compelling reason to delay implementation of the legislation for more than several months.

(4) Indexation of capital gains complicates the tax system.

A frequent argument raised against the capital gains tax is that since a large part of the capital gains are due to inflation, fairness requires that the value of the capital asset be indexed to a representative price index so that the inflation component can be exempted from tax. In line with this argument, the law firm Cliffe Dekker Fuller Moore Inc. points out that “South Africa has experienced high inflation rates for the last twenty years. Although there has been a substantial decline in inflation rates in recent years, inflation is by no means a thing of the past. Government has set its own inflation target of 3 to 6 percent. Even if these targets are achieved the inflation rate will still be well above that of most first world countries.” In addition, they point out that “the cost of collection of CGT is very high.”[21] The process of indexing capital gains for inflation increases administrative complexity and raises collection costs.

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[19] M. Kevin McGee, 1998. “Capital Gains Taxation and New Firm Investment”. National Tax Journal Vol. LI (1998), No. 4.
[20] Cliffe Dekker Fuller Moore Inc., 2000. “Capital Gains Tax”. Web-page article at internet address: http://www.cliffedekker.co.za/pubs/matters-CGT-1.htm
[21] Cliffe Dekker Fuller Moore Inc., 2000. “Capital Gains Tax”. Web-page article at internet address: http://www.cliffedekker.co.za/pubs/matters-CGT-1.htm

This argument, however, presumes that it is desirable to index capital gains inflation. In fact, the vast majority of countries that tax capital gains do so without indexation for capital gains. Furthermore, there has been a shift away from indexation in those countries that follow the practice. Recently, Australia eliminated indexation for inflation.[22]

(5) A capital gains tax "locks" taxpayers into investments.

A capital gains tax distorts the economy by "locking" taxpayers into investments because they seek to avoid the realisation of capital gains taxes triggered upon disposal of assets. The Katz Commission notes that the 'lock-in' effects of a realisation-based capital gains tax may have negative effects on free-market capital flows.[23] Nevertheless, this may also have positive benefits for the economy. A simulation model that accounts for household portfolio choice finds that "eliminating the 'lock-in' effect through a revenue-neutral move to accrual taxation causes national saving to decline, as households face a lower tax on present consumption from appreciated assets and, by reallocating existing wealth more efficiently, need to save less for future contingencies." A capital gains tax may actually be associated with higher national savings.[24]

(6) The tax will undermine our international competitiveness.

Opponents of a capital gains tax frequently argue that the tax will undermine international competitiveness by reducing incentives for investments that will yield capital gains. Nevertheless, many of South Africa's trading partners tax capital gains at a much

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[22] American Council for Capital Formation, 2000. "Capital Formation Tax Cuts Abroad" in Capital Formation, January-February 2000 vol. 25, number 1. Internet address is: http://www.accf.org/JanFeb00.htm#anchor1662073

[23] M.M. Katz et al. 1995. "Third Interim Report of the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa." Pretoria: Republic of South Africa.

[24] Alan J. Auerbach, 1992. "On the Design and Reform of Capital Gains Taxation". National Bureau of Economic Research Working Paper: 3967, January 1992.

higher rate than the rates in the proposed legislation. The table below compares cap

gains taxes in 24 countries.

International Comparison of Capital Gains Tax Rates

Country	Gross Domestic Saving as a Percent of GDP	Maximum Individual Tax Rate	Individual Capital Gains: Max. Tax Rate on Equities		Individual Holding Period
			Short-term	Long-term	
Argentina	18.0	33.0	Exempt	Exempt	No
Australia	21.0	48.5	48.5	48.5; asset cost is indexed	No
Belgium	23.0	56.7	Exempt	Exempt	No
Brazil	18.0	27.5	15.0	15.0	No
Canada	21.0	31.3	23.5	23.5	No
Chile	26.0	45.0	45.0; annual exclusion of $6,600	45.0; annual exclusion of $6,600	No
China	44.0	45.0	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Denmark[a]	21.0	61.7	40.0	40.0; shares valued at less than $16,000 exempt if held 3+ years	Yes, 3 years
France	21.0	58.1	26.0; annual exclusion of $8,315	26.0; annual exclusion of $8,315	No
Germany	21.0	55.9	55.9	Exempt	Yes, 6 months
Hong Kong[b]	23.0	20.0	Exempt	Exempt	No
India	31.0	30.0	30.0	20.0	Yes, 1 year
Indonesia	24.0	30.0	0.1	0.1	No
Italy	33.0	46.0	12.5	12.5	No
Japan	22.0	50.0	1.25% of sales price or 20% of net	1.25% of sales price or 20% of net gain	No
Korea	30.0	40.0	20.0; shares traded on major exchange exempt	20.0; shares traded on major exchange exempt	No
Mexico	34.0	35.0	Exempt	Exempt	No
Netherlands	23.0	60.0	Exempt	Exempt	No
Poland	26.0	40.0	Exempt	Exempt	No
Singapore	18.0	28.0	Exempt	Exempt	No
Sweden	50.0	57.0	30.0	30.0	No
Taiwan	22.0	40.0	Exempt (local company shares)	Exempt (local company shares)	No
United Kingdom[c]	N/A	40.0	40.0; shares valued at less than $11,225 exempt	40.0; shares valued at less than $11,225 exempt	Yes, 1 to 10 years
United States[d]	**16.0**	**39.6**	**39.6**	**20.0**	**Yes, 1 year**
Average	**25.2**	**42.4**	**19.4**	**15.9**	**79.2% have no holding period**

*Notes

Maximum Individual Tax Rate

[a] Maximum marginal tax rate is 20 percent for the assesment year 1997/1998 and 17 percent for 1998/1999

Individual Capital Gains

[b] Gains on shares held three or more years are tax exempt if taxpayer owns less than US $16,000 of the company's shares

[c] Sliding scale of rates applies to 1 to 10 years of ownership through an exclusion that rises gradually to 75 percent for assets held 10 or more years. Thus, assets held 10 or more years face a top marginal rate of 10 percent.

[d] Shares held 12 months or more are taxed at a rate lower than that on ordinary income under the IRS Restructuring and Reform Act of 1998.

Source: Study by Arthur Anderson LLP for American Council for Capital Formation Center for Policy Research.

The average capital gains tax rate in the sample is 19.4% for short-term capital gains and 15.9% for long term capital gains. South Africa's proposed maximum capital gains tax rate for individuals compares very favourably at 10.5%. Likewise, South

Africa’s proposed maximum tax rate on legal persons--at 15%--compares very favourably to the average in the sample--22.8% for short-term gains and 19.6% for long-term gains.

The issue of international competitiveness raises a very important question. Is a country more competitive if it exempts capital gains from taxation yet fails to support the conditions necessary for asset value growth? A rational investor prefers a taxed capital gain to a capital loss. Given South Africa’s social backlogs, the returns to socially investing the capital gains tax revenue may yield not only important social returns, but also nurture labour and capital productivity and reinforce the conditions for even greater capital gains in the future.

CONCLUSION

The law firm Cliffe Dekker Fuller Moore Inc. puts the issue of the capital gains tax into a political economy perspective: “CGT will work for the ANC. The debate is not really about ‘Can it work?’ but rather ‘How can we stop the rates increasing?’”[25] The debate over the capital gains tax is in large part political. Once it is accepted that the capital gains tax can work, attention can be focused on how best to employ this policy reform to achieve South Africa’s pressing social objectives.

A recent study by international economists argues that while globalisation can promote higher rates of economic growth, “there is no guarantee that capital mobility makes *everyone* better off.... risk-averse capitalists unambiguously benefit from international capital mobility. Risk-averse workers lose...” From a fiscal perspective, “tax competition is generally expected to drive tax rates down to inefficiently low levels....” The net effect of these two forces is that “capital market liberalisation calls for more

[25] Cliffe Dekker Fuller Moore Inc., 2000. “Capital Gains Tax”. Web-page article at internet address: http://www.cliffedekker.co.za/pubs/matters-CGT-1.htm

redistribution while making this redistribution difficult." International tax co-ordination c help to resolve this dilemma.[26]

South Africa's adoption of a capital gains tax moves the country's tax structure closer to international best practice. It serves to better co-ordinate South Africa's tax system with international standards, improving the management of globalisation in the interests of the country's social and economic objectives.

On balance, the proposed legislation evenly weighs the advantages and disadvantages of the capital gains tax and arrives at a policy reform that improves South Africa's tax structure and economic prospects. Given the politically volatile nature of the reform, many people will undoubtedly find fault with many aspects of the legislation. Nevertheless, the proposed tax is well crafted to achieve important policy objectives furthering social equity, economic growth and job creation.

[26] Dani Rodrik and Tanguy van Ypersele, 1999. "Capital Mobility, Distributive Conflict, and International Tax Coordination." National Bureau of Economic Research Working Paper No. 7150. June 1999. Cambridge, Massachusetts: NBER.