The Political Economy of Capital Gains Taxation in South Africa[1]

Part II: The Public Choice of Capital Gains Taxation and Public Policy

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ABSTRACT

Public Finance and Public Choice principles are used to analyze the ideological and practical basis for the proposed introduction of a Capital Gains Tax into the income tax system of South Africa. The paper concludes that this is a flawed tax whose time has passed – especially for countries like South Africa.

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> *It is unfortunate politics outweighs sense at such a critical time in South Africa's growth. There's no doubt in my mind capital gains tax is to be introduced for political, not fundamental reasons. It's a trade-off for concessions from labour over issues like privatisation.*
> Mark Shuttleworth, *Cape Argus* 13/2/2001.[2]

1 INTRODUCTION

This is the second part of an essay about the proposed Capital Gains Tax for South Africa (hereafter, **ZA-CGT**). The **ZA-CGT** was scheduled for introduction 1 April 2001, but postponed until 1 October 2001. The essay argues that, indeed, such a tax does not make sense. It should not be introduced, or even just be postponed again in October, but rather permanently excluded from consideration in the future. It is paramount for South Africa's future development and growth, and for arresting and reversing its recent fall of savings rates, that investors, large and small, domestic and foreign, be signalled that the government intends to be "capital friendly".

While the arguments in this essay do have support in recent public finance and public choice literature, they are admittedly used in a way that supporters of **ZAGT** may characterize as "political". This is unavoidable, given that the acceptance or rejection of any tax is inevitably political. Those who expect to be harmed will lobby against the tax; those who expect to gain by it will lobby in favour. Often their opposition or advocacy is based on the anticipated impacts of the tax on their own special interests, even though economists, in contrast, argue that the ultimate effects usually differ from the expected impacts.

In light of the foregoing, the objective of this essay is to consider the issue from the standpoint of the so-called "general interest" or "public interest". The framing question is: "Will this tax be beneficial for most South Africans?" The answer given here is: "No!"

That "No" is not only an analytical, economic judgement, but also a political judgement. However, it is not "political" in terms of taking sides against the government or particular political parties or particular special interests, because the governing party and most special interests, as well as most individual South Africans will be ultimately better off without the **ZA-CGT** "albatross". Positive proof of that is impossible, given that it involves the future and many unknown but determining events. Thus, this essay is unashamedly aimed at affecting rational beliefs and expectations by the use of informed and rational argument.

2 THE PUBLIC CHOICE OF CAPITAL GAINS TAXATION

2.1 A Primer

Public Choice differs from Public Finance in that it subjects the political sphere of an economy to the same analytical methodology as the commercial sphere. In this approach to the political "game", the individual players, that is, the voters, politicians, bureaucrats, etc., regard their own self-interest as foremost in determining their behaviour within the confines of political institutions and structures – administrations, bureaucracies, legislatures, interest groups, etc. Politics is exchange – exchange between voters and politicians, between politicians to form administrations and agree on public policies, between administrations and bureaucracies and lobbyists for interest groups, and so forth. For example, tax and spending proposals will attract the attention of affected interest groups and they will often use real resources to promote or defend their interest through the political system (Becker, 1983; Alesina & Rosenthal, 2000) and even the court system (Farmer & Pecorino, 1999).

Public Choice analyzes these political competitions with a view to assessing their efficiency with respect to establishing individual-, group-, and public-interest outcomes (choices), as well as their overall economic effects on the economy as a whole. Unlike the usual neoclassical analysis of competition, Public Choice does not find competition to be costless. Besides those costs analyzed in the Transactions Cost literature, such as information, negotiation and enforcement costs with respect to particular contracts, there are transfer- or rent-seeking or rent-defending costs over the very rights subject to contract. These "meta" or "political" transactions costs are known as "Tullock Costs", after their modern discoverer, Gordon Tullock (1967). Tullock Costs can under-, over-, or exactly dissipate the net welfare or social surplus from political and/or legal action.

2.2 Economists' Role

The Public Choice approach involves a much different role for economists as public finance advisers. Namely, economists are not just advisers but also a source of ideology and another interest group. As policy advisers, they may be a strategically placed interest group – in that they may more directly have politicians, bureaucrats, and/or the public's rapt attention – but they are usually not a group with political clout in their own right (unless they actually become politicians and achieve higher office as indeed a select few economists have done).

However, in the past, economists have usually served at providing economics-based, general-interest rationales for policies that are politically viable on other grounds – usually again, based on the winning or dominant special-interest groups' own interest. Indeed, education or re-education, and promotion of mainstream or neo-mainstream ideas, have generally been economists' main political functions. Often textbooks, as well as advanced treatises, are simply political platforms seeking a sponsor or a constituency – just like Machiavelli with his own self-serving treatise, *The Prince*.

In a sort of "Economic Darwinism", the political system selects those economists whose ideas are most useful in constructing dominant and winning coalitions of interest groups or economists who are best at providing the technical support for those ideas. We need not question the sincerity or the technical competence of economists and public finance specialists elevated by this Darwinian process. In this respect, it is the political incentives that are responsible for apparent inconsistencies between theory and practice, not the individuals *per se*. Practice follows the "winning" theory! The winning theory on any occasion need not be logically consistent with winning theories on other occasions as long as it is essential in reconciling dominant political interests.

We can easily imagine that this may well have been the case for capital gain taxation (hereafter, **CGT**). Public finance advisers, from much before Samuelson and Musgrave in the 1950s to much after the 1967 Canadian Carter Commission, have provided general-interest rationales and slogans. The "Schanz-Haig-Simons" (hereafter **SHS**) consistency notion is characterized by the slogan "a buck is a buck". Simon's horizontal equity notion is characterized by the slogan "equal treatment of equals". The Carter Commission's concern with allocation efficiency for corporations is characterized by the slogan "dividend stripping". This sloganeering is aimed at supporting tax code changes to provide political fixes. It elevates a simple problem to the status of a necessary desiderata or an unnecessary evil – mainly intended to attract public attention and support for remedying public action.

Somehow, these consistency-driven programs never result in the perfect "fix" or "reform". Periodically, the "fix" must be redone. The tax system is "reformed" periodically by fiddling with the tax rates or specification of the tax base. This has been characterized this as a "tax reform cycle" (Spindler & Walker, 1988).

2.3 Why a CGT Now?

Recently for South Africa, Katz (1996) gave a realistic and balanced presentation of the pros and cons of **CGT**, finally coming down on the "con" side because of administrative inadequacy at the time of the Report. What changed since 1996 to alter the force of Katz "not for now" recommendation? The casual observer would probably say "not much" – at least with respect to administrative competence, where press reports of inadequate accounting for funds are at least as embarrassing to South Africa's governments as one might find in (say) Canada (which should know – but cannot do – better). Unfortunately, in almost every country throughout the world, governments' appetite for control exceeds their ability to control.

Is there an excess supply of well-trained accountants and auditors available to buttress the government's revenue bureaucracy (and to enhance the avoidance ability of their private counterparts). If so, perhaps they could have a more fortuitous effect on the government's deficit (surplus?), and/or on its productivity, by deploying them to achieve better financial and production control over all its bureaucracies. Introducing a new tax, with innumerable prospects for avoidance and evasion, will likely decrease the availability to government of trained auditors and accountants as they are hired away by private firms, where they will be more productive and, hence, better paid.

2.3.1 Bureaucrats' Interest: However, the revenue bureaucracy has an interest in being a major supporter, and even an in-house lobby, for such increases in demand for its services and the associated increase in budgets. Even evidence of public lobbying can be found in recent newspaper advertisements (e.g. *Cape Argus*, February 16, 2001) placed by the South African Revenue Service (SARS) rationalising the **ZA-CGT** (under the guise of explanation) before it is even approved by Parliament – a clear violation of the principle of civil service neutrality.

As a result of their support and lobbying, bureaucratic salaries will rise with the associated increased public sector demand and increased private competition for their services. Their government salaries may not approach the levels privately available, but they will generally be disproportionately high compared to the time required and the talent displayed. This interest group has a definite interest in more complex tax systems. Here, at least, revenue bureaucrats will be very consistent!

Of course, to the extent that they manage to generate net revenue over and above the marginal administrative cost of a new tax, they will also get the support of other bureaucrats in other bureaucracies, which will compete within government for the right to deploy extra funds disproportionately. In the **ZA-CGT**, however, other SA bureaucracies will be disappointed, since the **CGT** is famous for being relatively unproductive of net revenues (See Burman, 1995, 1999; Grubel, 2000; Katz, 1996; Lee, 1995; and Zodrow, 1995).

Indeed, for a government that is"competence-challenged", CGT may be a net user of funds, when all government money costs are counted.
Recently, the Ministry of the National Treasury (Finance Ministry) has partially privatised tax collection in South Africa. Thus, instead of bureaucrats in the Receiver's office having a vested interest in tax complexity, that interest is transferred by privatisation to private professional firms.

2.3.2 Private Interests: Other private interests on **CGT**, both pro and con, might be noted. Private tax accountants and tax lawyers have an obvious professional interest in a more complicated, but professionally understandable, tax code (See Richardson, 2001). Indeed, they are often called, or they offer, to give testimony on the practicality of tax changes.

When they are representing their profession, they will be concerned with maintaining their profession's set of standards – which gives them the unique property-right, and the quasi-monopoly professional restrictions that may make their profession, their professional qualification, and their own human capital, more valuable. This will often take the form of devising and advising a sufficient degree of tax-code "encryption" in order to put valuable avoidance schemes allowable under the new legislation just beyond the understanding of the above-average, non-professional taxpayer, while yet within the range of understanding of the above average professional.

The testimony and lobbying of these professionals may, on occasion, be on behalf of their clients and their clients' interest. In these cases, special exemptions will be sought on behalf of their clients or their clients' interest group. These special interest exemptions will be said to be in the general interest, as on occasion they may well be – especially in the case of legislation that is not generally beneficial.

In the case of the **CGT**, the exemption may involve some special feature of clients' businesses or occupations. For example, the sale of farms may be exempted from the **CGT**. Alternatively, some special, clever application that only a specific tax or law firm understands may earn that firm a very valuable "property right" to additional consulting and income.

Also, professional firms, and even charismatic professional individuals, might be quite entrepreneurial in developing special-interest groups under their control to provide financing for their lobbying activities. Of course, special interest groups might also develop spontaneously to lobby **CGT** pro or con. Or, groups existing for other purposes, for example, farmers' organisations, may find that they are economical conduits of their members interest re lobbying the **CGT** as well as lobbying for their original purposes. "Not that there is anything wrong with" such private actions. That is how representative, democratic government works – when it works at all.

2.3.3 International Interest: Other national governments, and often by extension, international agencies like the **IMF**, the World Bank, the **WTO**, etc., might also from time to time act to influence a country's government in order to pursue their own policy objectives, or, sometimes worse, policy objectives that they think are in the interest of that economy or the world economy. Needless to say, on some occasions their political pressure, not to mention political contributions, may be hard to ignore or resist. In South Africa's case, there may still be considerable pressure to comply with conventions which are more beneficial to those applying the pressure, and the nations they represent, than to South Africa, *per se*.

Among other conventions governments attempt to make common are those applying to tax systems. It is, of course, in the interest of a country with a high tax regime, that other countries co-ordinate their taxes and tax rates with theirs so as to reduce avoidance by their citizens moving their capital and/or themselves to countries with more favourable tax regimes (See Jones, 2000).

Frequently, a number of countries with high tax regimes will not only act to co-ordinate their tax systems with each other, but they will also mutually attempt to pressure low tax countries or tax havens into compliance, sometimes under a banner of serving the general interest of the world community. An example of the latter may be the US attempts to pierce Swiss banks' veil by using arguments about international crime or drug control, or retribution for Holocaust victims. When major countries act together to co-ordinate taxes, they are a *de facto* "tax cartel", which like the oil cartel, OPEC, might be expected to act in their members interest at the expense of non-members (Jones, 2000).

In South Africa's case, it can only be observed that the **IMF** has regular visits and position papers on various economic and public finance issues, and the US, as well as Canada, has moved to restore tax conventions which were dropped during the latter years of *Apartheid.* Indeed, in his comments on his 2000 Budget initiatives the Finance Minister did mention that the **ZA-CGT** proposal would help South Africa "rejoin the civilised world", which could be read as a buzz phrase signalling that tax co-ordination objectives were at play.

2.3.4 Politicians' Interest: Ultimately, in a democracy, politicians, and their parties, must promote and deliver public policies that attract the support of a sufficient number of citizens and voters to enable policy implementation and to win (re-) election. When the general public is non-homogeneous with respect to political interests, as is often the case in modern, especially multi-ethnic and multi-cultural, societies, parties and politicians will attempt to package together many diverse and sometimes contradictory and inconsistent policies to form coalitions of interest groups within the society.[3]

The object is to achieve and maintain a dominant coalition that will provide for a single party and a select group of politicians the basis of the power to govern. That is, this political group captures, perhaps only momentarily, until the next election, or for life, the legitimized and jointly held property right to govern on behalf of other interest groups and in the name of the general public.

The essence of this winning or dominant coalition is that its constituent groups have paid for policies favouring their interest by accepting policies that favour the interest of other groups in coalition (Tullock, 1997). The latter is the price that must be paid by each group that joins and/or remains in the coalition. Generally, policies favouring the special interests of coalition supporters will be designed to "concentrate the benefits" (to its sponsoring special interest group and perhaps to other coalition members as well) and "disperse the costs" (beyond the sponsoring interest group and preferably beyond other coalition members to the more general public).

The South African government's **CGT** proposal may be considered in light of this public choice insight on the political market place. The present **CGT** proposal is relatively limited with respect to assets covered and groups immediately affected. Its intended targets (victims!) are South African companies and relatively wealthy individuals resident in South Africa – essentially, the white, business community and foreign permanent residents.

These targets are relatively well organized along interest group lines and recently (post-transition) have been supporters of the government's relatively pro-business, pro-growth policies. For them, accepting the **CGT** (after appropriate modifications, as previously described) may be simply a price that must be paid for the policies favouring them and delivered by the governing parties.

The governing parties must also worry about keeping its own coalition of interest groups, and its more general supporters, on side by delivering policies favouring them and ideologically favouring the general interest. Seven years after South Africa's "transition", it is still the case, that the general interest is often interpreted as being served by redistribution policies under various justifications.[4] Here, the **CGT** may be viewed as serving as a "token" complying with that presumed ethic –perhaps in lieu of more substantive, but economically more destructive redistribution policies. It is a digression from the *de facto* policy of "talking left, acting right" during the post-transition.

2.4 Who is Burdened?

However, the governing parties must also look to the future. It may be that richer SA whites may seem to pay this tax at first. However, the rest of the population will eventually be the ones paying, as well as bearing the **CGT** burden because: a) The **CGT** base will inevitably be broadened. b) The tax will be shifted by avoidance reactions. c) As the rest of the population advances economically – if other government policies are successful enough to offset or overcome the economic effects of this one – they will increasingly find themselves subject to this tax.[5]

2.4.1 In Specific For example, ambitious entrepreneurs, like (say) the Cape Flats' enterprising squatter-builder-landlords, may well find themselves subject to excessive capital gains taxation when they sell their accumulated holdings because these assets will appear to have a (formal) zero cost base. The explanation that the government is trying to prevent them from escaping income tax on the accumulation of their (unpaid) labour and entrepreneurial services, will not make them happier, when they are poorer as a result.

However, they may perceive that their best response to the prospect of paying this tax is to avoid having sales flow through the formal sector. If that proves impossible, or if the Receiver of Revenue is likely to discover and close off this avoidance route, their next best response may be to join and/or financially support the governing parties in an attempt to be exempted from the **CGT**'s bite. Business people of all races, creeds and ideologies often seem to sense these political opportunities very quickly. Indeed, that sense is their specialized ability that often yields them excess returns. That leads us to our next Public Choice point.

2.4.2 Is CGT a "Cinch"? It is well known among US historians that during the 19th century, US politicians and political parties often proposed bills that were mainly intended to raise political contributions from the apparent non-beneficiaries or "victims" of the bill. At that time, these were known as "cinch bills". More recently, they have become known as "milker bills" (McChesney, 1987) because they are intended to milk campaign and lobbying contributions from potential targeted industries, groups, or individuals.

Is it really being too cynical, as public choice is often challenged, to imagine that the **ZA CGT** might be such a throwaway item? We will see who is "fooled" thereby next 1 April 2001. (This last line was written prior to the 2001 Budget announcement that the **ZA-CGT** would be delayed, so I have kept it in as a potentially confirmed speculation. 1 October 2001 may be the occasion for more "fooling"!).

In practice, few potentially footloose businesses – especially those that are multinational – pay taxes at legislated tax rates. Rather, they pay at "negotiated" rates that apply only to them, or at "net" rates after subsidies that apply only to them. The "consideration" offered as a *quid pro quo* for special rates may be extra domestic investment, the use of politically favoured or politically affiliated factor suppliers, contributions to parties and politicians, and so forth. Those in the know can tell such stories even about South Africa. In this regard, it is particularly disingenuous, and just not credible, to promote the **CGT** as important for improving the consistency of the South African revenue system. Whether it stays or goes, its actual effect will most likely be quite the opposite.

2.5 CGT Social Cost

We are now in a position to suggest that the net social costs of the **CGT** may be quite high. When compared to the expected social benefit of this tax, it may be the case that there is no social gain, or perhaps, even a net social loss. Of course, Public Choice economists might be the first to admit that this is difficult to prove one way or the other in practice for any specific case. The argument is mainly theoretical and relies on the presumption that open competitions among well-informed individuals eventually exhaust the surplus subject to the competition. The exact mechanism has been demonstrated theoretically in the Becker article mentioned previously. Political competitions induce both competitors to spend more, sometimes in real resources representing real social costs, than without the competition.[6]

The analysis of the immediately preceding sub-section suggests that it may be in the interest of political parties to induce such competitions whereby the party and their members benefit – whether or not they win elections and or hold the balance of political power. Again, if this uses real resources, this may be seen as a social cost. However, we also must stress that this may not be an avoidable cost and that efficient political parties and political interest groups will have a joint interest in minimizing such costs, if they can capture and share the resulting surplus.

By the "comparative-institutions approach", no set of institutions can be said to be inefficient or to fail unless there is a better institution realistically available. However, a superior mechanism for making public (private) choices may be efficient (relative to realistic alternatives) but still costly. In this regard, we might consider whether the proposed **CGT** is really the best way to accomplish government and party financing. The record elsewhere suggests that **CGT** is one of the most frequently lobbied taxes (other than, say top marginal rates or specific exemptions). The social costs are likely to be higher than alternatives if this experience generalizes to South Africa.

3 WWW, GLOBALISM, POSTMODERNISM,[7] AND PUBLIC POLICY

Welcome to the 21st century! Let's rethink the future.

3.1 Discard Modernism

It is a good time to sort out and finally leave behind the unfortunate ideological baggage from the recent past and to carry forward with only those ideas that will serve us well in the future. Considerable discarding was done already during the last decade or so of the 20th century, but much more remains to be done in that regard.

The fall of the Communist monolith dealt the deathblow to one version of what has been called "corporatism" – an ideology that essentially defined what it meant to be modern with respect to government forms (Todd, 1995). Another venal version of corporatism, fascism, was extinguished at mid-century, though remnants struggled on for a while in non-central societies – such as with Spain's Franco, Portugal's Salazar and with South Africa's *Apartheid* – until they gave way to more democratic forms. But democratic corporatism is still very much with us. Indeed, it is still the major vehicle of advancement for those inclined toward stable careers while simultaneously entertaining a lust for power over others – in the name of others' own good, of course!

It is arguable whether corporatist obsessions were on balance beneficial during the 20th century. The problem was that there were no natural checks to the concentrated and unfettered power that such ideology justified, except for the ambitions of other corporatist states, and catastrophic events such as war, revolution, social collapse and other excuses for mass genocide, democide, and excessive non-productive government expenditure. However, during the closing decades of the 20th century, the market re-emerged as a credible voluntary alternative to coercive government for solving social problems.

3.2 Back to the Future

In some ways, that has set the stage for more rapid and better-balanced growth like that which occurred during the 19th century, when the world economy was far more global than it was during most of the 20th century. Labour was certainly more internationally mobile then (passports were generally not required) as were goods (tariff and non-tariff barriers were far lower then than now, even after many rounds of **GATT** and **WTO** negotiations). Only capital may be arguably claimed to be more mobile now. But that may be due more to the rapidity of capital movements rather than on the basis of relative size.

The Internet or World Wide Web has become a vehicle for democratizing or individualizing capital movement both of the human or non-human variety – either real or virtual. At a touch of a mouse and keyboard one's wealth can be transferred, and one's income earned, away from any jurisdiction that taxes excessively for the government services provided, or that issues its currency excessively in a desperate attempt to gain revenue at the expense of long-run credibility.

Individuals, not states, will be sovereign – or at least, this is the well-argued vision of Davidson and Rees-Mogg (1997). Even if their vision only reaches fruition in part and/or eventually, governments will have to reconsider their redistributionist ways. Otherwise, like Robert Mugabe, and dozens of other despotic kleptocrats, they will find it ever more costly to redistribute less and less, as the productive capacity of the economy is starved and gutted by human and non-human capital flight – virtual or real.

Perhaps major states, spanning large geographical areas may seem relatively immune from these influences. However, the fall of the USSR demonstrated quite convincingly that even superpowers can collapse from within (and some argue that the Internet played a facilitating informational role). There is little doubt that smaller states can only ignore these worldwide institutional and technological advances at their own peril. The implications for tax systems are crucial.

3.3 The Magic of Flight

Even the anticipation of differential taxes on capital and/or capital income might produce capital flight that would reduce the revenue base immediately - even before the tax is in place. Among other things, this complicates the measurement of the impact and ultimate effect of any anticipated tax, if these effects are presumed to occur after the tax is legally in place (The "*post hoc, ergo proctor hoc* fallacy.")

Further, labour income, or rather income from human capital, can also avoid taxation by emigrating virtually or *de facto*, failing to immigrate in response to other economic incentives, or, perhaps the worse curse for developing economies, never developing in the first place. What statistician or econometrician can reliably measure data that has not occurred? What social scientist Sherlock Holmes will ask about "the [data] that did not bark"?

3.4 Comparative [Tax] Advantage

Postmodern development theory is returning to the view that an open economy and privately motivated, directed and internationally transferred capital, both human and non-human, along with their embodied technology, are absolutely essential for rapid development that can catch-up with and surpass the mature economies (Jones, 2000).

> ***Differential domestic taxes on internationally mobile factors are the equivalent of tariff and non-tariff barriers and capital controls in that they retard capital movement today and development tomorrow.***

The proposed **ZA-CGT** will be introduced at a relatively low rate, say, in comparison with mature economies like the US, the UK, and especially with high **CGT** rate Canada. It might be argued, as SA technocrats recently have stated publicly, that such a low rate is unlikely to induce massive or even any capital flight from here to there. A minor counter argument is that it might just tip the balance (See endnote 1) – encouraging emigration and discouraging immigration of both human and non-human capital. This may be especially the case for people who are already dissatisfied with the post-transition state of the economy and society, or for those prospective immigrants who find Home Affairs immigration procedures (often time and resource wasting for those rich in human and non-human capital) much too constraining for their own good as well as South Africa's. Those who can and will move freely are often exactly those who government needs to convince (not coerce) to come and to stay.

Another less minor argument is that this may be just the tip of the capital-gains-taxation rate iceberg. Historically most **CGTs** have been introduced with low rates and limited coverage only to be raised and extended, respectively, as governments search in vain for that mother lode they expect must ultimately be uncovered by their efforts.[8] Rational investors and economic migrants will anticipate eventual compliance with this pattern in South Africa as well.

The major counter argument to the **ZA CGT** promoters' "low introductory rates as benign" argument is that South Africa is not in competition with those more mature economies with respect to promoting rapid development. It is in competition with countries like the Asian Tigers, most of which have no capital gains taxation, low, flat, rates of tax on income, and few redistributive social programmes.

South Africa should not attempt to harmonize its tax system with systems in mature economies. Their low per capita growth rates would never do much good here for those seeking a more advanced standard of living. Instead, South Africa should harmonize its system with those who still are on their way up at exceptional rates of growth year after year. Like the famous ad for E F Hutton, when those rapid growth countries' policies "speak", South African policymakers should listen. Advisors from mature Western economies, and/or international agencies have their own vested interests, and the "gifts" they bear may prove too costly in the end.

To emulate and compete with the most successful Asian Tigers, South Africa should not only avoid taxing capital or capital gains directly, but should also avoid indirect capital taxes like foreign exchange controls, property-transfer tax rates exceeding administrative transfer costs, and taxing on the basis of residence rather than source.[9] Further, coordination of company and personal taxes should be achieved by using the same low top marginal rates or, even better, low flat rates for both. Finally, tax revenues should be used to fund productive government infrastructure maintenance and improvement (which generally leads to greater direct and indirect employment prospects), rather than used to fund unproductive transfers (which generally divert the recipients from productive employment to the status of impoverished "rentiers").

While South Africans in total shoulder a relatively low tax burden as measured by the ratio of government revenues to GDP (roughly 28 per cent), actual taxpayers shoulder an excessive burden because they are so few as a proportion of the total population (roughly 4 out of 40 million for income tax). There is indeed a scarcity of taxpayers that will not be remedied by introducing extra tax bases that hit the same over-burdened taxpayers. Rather, lower, or even zero, rates must be deployed to encourage an expansion of formal-sector economic activity and an increase in the number of actual formal-sector taxpayers.

Indeed, all South Africans would benefit by South Africa becoming a relative tax haven for capitalists – especially those developing or bringing their own "intellectual capital". This would expand the existing income and VAT tax bases and increase government revenues to a greater extent than any tax tending to drive capitalists away or into hiding. Indeed, it would also hasten every South African toward becoming a capitalist (as an owner of human and/or non-human capital), as will be required in a truly globalized future.

A little known, or appreciated, fact is that South Africa was on par with Japan in 1957 in terms of per capita income. At about the same time, Zimbabwe (then Rhodesia) was about on par with South Africa. Reflecting on the differences between those countries' past policies and their current real per capita incomes should provide a sound basis for drawing some sober conclusions. 1) Institutions matter. 2) Political redistributions to special interest groups tend to handicap an economy. 3) Economies open to trade, and especially capital movement, generate superior per capita performances.[10]

3.5 Handicapping Freedom

Such observations for particular countries have now been generalized for nearly the entire world following the development of Economic Freedom Indexes, which are highly correlated to many of the desiderata of advanced, postmodern life – including per capita income and (surprising to some) its favourable (market) distribution. Tax rates play a major role in determining the value of these freedom indexes.

South Africa was ahead of other African countries by these measures even before its transition. But following that event, the new government has, up to now, performed well enough for South Africa to leapfrog 8 rankings over its rivals between 1990 and 1997. However, it is still far from the highest ranked countries.[11] Capital unfriendly taxes will ultimately lead to a lower ranking, and, eventually, poorer development results.

3.6 Postmodern Public Finance

One cannot help but be impressed by the difference between the ideological thrust of major Public Finance textbooks and that of the articles contained in academic journals specialising in Public Finance. While both might be said to share the modernist preference for state intervention, and both tend to ignore the warnings of Public Choice (though the journal articles much less often), the latter are much more ideologically and analytically diverse in their perspective. In true postmodern form, they often tend to contradict and/or challenge their predecessors – sometimes with a self-conscious promotion of pre-modern ideas – especially ideas favouring efficiency over equity (See Coleman, 2000; Fuest & Huber, 2000; Lansing, 1999; Parker, 1999; Sillamaa, 1999; Ueng & Yang, 2000).

Perhaps the time is right for a great, Public Finance synthesizer, much like R A Musgrave of two generations earlier, to arise to present a new consistent version of the discipline. Perhaps! But we might well be the worse for it. There is always the chance that, like with Musgrave's, or even Keynes's, "discipline revolution", an entire generation of policy analysts, and, hence, government policy actions, may be misled as a result.

However, to avoid such misadventures, it is important for political observers, critics, and policymakers to recognize the lack of consistency and consensus in the discipline. Again, in true postmodern form, it might be said that the discipline has become multi-cultural! Many ideologies and technologies are in active competition for political influence. In this context, attempting consistency to some outmoded standard or ideal may be true folly – with unfavourable, if not self-defeating results.

Keynes really said it best: "Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." Who could he have had in mind when he said that? Many of the Modern politicians, as it turned out.

It is now time for politicians to be Postmodern.

4 CONCLUSION (Parts I & II)

In a sense, South Africa is starting with an almost clean slate with respect to certain kinds of income taxation. It should strive to keep that slate as clean and simple as possible. In the name of consistency, the introduction of capital gains taxation in any form, will multiply, not reduce, the system's inconsistencies. In the name of equity, it will multiply the inequities. It will not raise substantial net revenues. But it will be a source of ongoing lobbying activity, and that will undermine social cohesion.

In the short run, **ZA-CGT** may yield political and financial benefits for the governing party. In the long run, if that party's constituents' market prospects improve as a result of other government policies and/or market developments, its own prospects are likely to suffer. Every time a constituent's income earning or wealth gaining prospects are blocked or reduced by the presence of a **CGT**, votes and financial support will be threatened. The "financial cows" will increasingly avoid that party's "milk house"! Other parties will offer alternatives in order to farm this ever more fertile avoidance field. The prospects for the economy will be diminished by the incentives to divert resources from market to political opportunities.

Our "Modern" Past is now Prologue to our "Postmodern" Future. Modernist failures were very costly lessons for those who have learned well enough to create a more successful future. In brief, some of the more important of the lessons and ideas essayed, but not proved, here with respect to **ZA-CGT** are:

Consistency is economically and politically elusive.
Capital gains are not past income that avoided taxation.
Capital gains taxation reduces available capital and wealth.
Capital gains taxation is inefficient and uneconomic.
Efficient tax policies promote equity, not vice versa.
South Africa should be more of a "tax competitor" than a "tax co-operator".
South Africa will develop faster without a CGT.

Each of these is arguable and subject to *caveats*, but nevertheless captures some essential truth that can be worthwhile believing.

Convincing policymakers and their constituents to listen to and to understand these lessons will not be easy. But this essay is a start.

ENDNOTES

1 Thanks are due to D. Allen, J. Chant, H. Grubel, D. Hammes, R. Jones, B. Kantor, R. Krelove, J. Seinfeld, and J. Stuart.

2 The rest of South Africa's first IT billionaire's prescient quote in response to *Cape Argus* reporter Nazila Peer's question: "What do you think of the capital gains tax?" is:
It's essentially a very complex, bureaucratic tax that introduces

uncertainty, when we should be encouraging economic growth and wealth creation.
[Paragraph quoted in text fits here.]
I don't believe a capital gains tax will bring significant inflows into the treasury. More resources will be diverted into the hands of accountants and financial advisors than will actually create economic growth.
In early March 2001, it was reported that Mr. Shuttleworth just emigrated to the UK, for reasons of business and remaining SA exchange controls. He denied that the proposed **CGT** was responsible, although it is the main new intrusive element on SA's business horizon, and revealed preference theory suggests otherwise.

3 That such packaging can easily cause confusion among political observers is well demonstrated by an article entitled "Our government suffers from ideological schizophrenia" by S. Mulholland in the 18 March 2000 *Sunday Times.*

4 "Robin Hood" (rich to poor transfers): "Manifesto" ("from each according to her ability, to each according to his need"); retribution (compensation for previous government induced injuries); or restoration (restoring entitlements gained by defeating others but taken away when last defeated). In South Africa, various claimant groups have what might be called "entitlement myths". Each group's myth specifies that its group was historically the first claimant to various land tracts, or indeed the entire country. Under the age-old rule "first in time, first in right", that myth then justifies their claim for restoration of rights, which, in fact, their specific forebears may never have held, or may have voluntarily sold or simply taken away from others who came before them. The historical evidence seems to be that this region was continuously occupied from the dawn of time by peoples who may no longer be well represented in SA's existing population. Strictly speaking, then, no current group would have a dominant claim on the "first in time" basis. But practically, if a group has a majority – or even a controlling minority, as did the Afrikaners for a while – it has the power to make its own myth operational. Other myths, even that these myths are myths, then become politically incorrect and precluded.

5 This suggests the need for a "golden rule" principle of taxation. The golden rule is seldom discussed in Public Finance literature, but quite relevant in a dynamic – especially an inflationary – context as progressive taxation eventually expropriates its own earlier supporters. Further, it may be noted in this context that those who are exempt from taxation, such as IMF advisors, are inappropriate tax advisors. Finally, "Rule of Law" ideology of equal treatment under law, even for advisors, bureaucrats, legislators, and other politicians, has a certain logic for promoting incentives to make and enforce more reasonable law.

6 Where will this political competition, or rent seeking, costs, occur for the new **ZA-CGT,** or for any new tax rule or law? Let me count the ways: 1. Preparation. 2. Legislation. 3. Administration. 4. Compliance. 5. Avoidance. 6. Revision. 7. Repeal; and so on – possibly in a cycle. At each stage there will be costs for the government as well as all of the competitors, which must be summed for the total social cost.

7 This term has not been used often in economics, although it is indeed appropriate. For those unfamiliar with postmodernism, here is a definition:

A term used to designate a multitude of trends in the arts, philosophy, religion, technology, and many others that come after and deviate from the many 20th-century movements that constituted modernism. [...] Widely debated with regard to its meaning and implications, postmodernism has also been said to relate to the culture of capitalism as it has developed since the 1960s. In general, the postmodern view is cool, ironic, and accepting of the fragmentation of contemporary existence. [...] and [challenging] a wide variety of traditional cultural values. (*The Columbia Encyclopedia*: Sixth Edition. 2000).

8 Again, Canada provides a bad example. Since its 1972 introduction, the relative rate on capital gains has increased and the exemptions have decreased to the point where only first home rollovers are exempt.

9 Unfortunately, South Africa has already moved to residence based income taxation. This is a major mistake – perhaps even more so than a CGT – and a very bad signal to foreign capitalists who might want to personally direct their South African investments by taking up residence in South Africa. It discourages such direct investments and/or encourages dishonesty and subterfuge about offshore assets and income. Only countries that have large internal markets and the military muscle and financial leverage necessary to pierce other countries' secrecy and privacy rights, like the US, can gain from using a revenue-based, rather than a source-based system. Any country moving to a revenue-based system will only make the US, and actual tax havens, seem more attractive.

10 For a quick, non-technical survey of the lessons to be drawn from the successes and failures of "Modern" development during the 20th century, one should read PJ O'Rourke's ironically entitled *Eat The Rich*. It is the best, popular-press book on economic development since Adam Smith's *Wealth of Nations*. However, it is not alone in the field, as many new treaties on "why capitalism won" have been published over the last decade since the "fall of socialism".

11 South Africa's 1997 Index Rating: 6.5 (out of 10); Ranking: 56 (out of 119 countries); 1990 Index Rating: 5.4 (out of 10); Ranking: 48 (out of 111 countries). See *Economic Freedom of the World: Report 2000* at www.freetheworld.com.

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