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Tax: Why align with "most other countries"?

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When Pravin Gordhan announced a new 15% dividend tax to replace the 10% secondary tax on companies, along with jacking up the capital gains tax rate, he said he wanted to bring SA in line with “most other countries”. Why would anyone want that?

“Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice,” wrote Adam Smith, in the pre-history of modern economics.

By contrast with “the highest degree of opulence”, quite a lot of “other countries” are in a bit of a pickle, as an attentive minister might have noticed in the newspapers. The tax-and-spend welfare states are chief among them, and countries that were forced by treaty to align their monetary and fiscal policies with “most other countries”, like Greece did to join the European Union, are in a particularly nasty spot of bother.

If we must emulate other countries, why not choose those who doubled their per-capita incomes in 25 years, despite starting out with problems that to most developing economies seem insurmountable?

There are spectacular case studies of Adam Smith’s principle about “easy taxes”.

Hong Kong, for example, doubled its per-capita income between 1947 and 1967, and it would go on to become the model against which all south-east Asian success is measured. It did so not only without the detailed five-year plans that were at the time popular in the region, but with hardly any government intervention at all.
Sudha R. Shenoy, then a graduate student in economics at the School of Oriental and African Studies, University of London, noted a startling feature of Hong Kong as a developmental state.

In a 1969 journal article, she wrote: “...there are still no official national income estimates, or even an Index of Industrial Production. There are no official balance-of-payment figures, no restrictions on trade and payments, no export duties, no central bank; banking regulation is negligible. Consequently, the government simply has no basis for applying the various fiscal, monetary, and other measures recommended in most modern textbooks on public finance and development."

The state couldn't intervene in the economy, or raise exorbitant and complicated taxes, because it had no idea what to tax. Hong Kong faced grave problems that we'd nowadays associate with a "poverty trap", such as having almost no natural resources, and having to import all its food, fuel, raw materials and even drinking water. It had almost no labour laws, no minimum wage and weak unions. It received no foreign aid.

Despite all this, it had ten times more industrial companies in 1967 than in 1947, and employed more than eight times as many people. Exports of manufactured goods rose 4.5 times in just the 12 years between 1953 and 1965. It never suffered a shortage of foreign exchange earnings. Take-home pay doubled between 1958 and 1967, while prices rose only 9% in total over that time, indicating a mere 1% annual rate of inflation. Living standards rose, and rice consumption declined in tandem with a rise in meat and vegetable imports.

Its tax regime forced it to fund its welfare and infrastructure spending entirely out of economic growth, which it did. Today, Hong Kong's corporate tax rate is a modest 16.5%, and personal income tax is never more than 15%.

By contrast, South Africa's corporate tax rate is 28%, and personal income tax tops out at 40%.

More recently, the contrast between the relatively free economy of Chile, the mixed economy of Argentina, and the "developmental state" economy of Venezuela, offers an equally compelling example.

Venezuela was the richest of the three in 1980, with a per-capita GDP of $10,000. Argentina was worth $8,000 per capita, and Chile trailed at $6,000.

The late Angus Maddison, a scholar on macroeconomic history and economic development at the University of Groningen and a founder of the Groningen Growth and Development Centre, covers Chile's rejection of ruinous socialist policies and adoption of free-market economics in his two-volume opus, *The World Economy*.

Despite a nasty military dictatorship before today's stable democracy was achieved, Chile's GDP per capita had more than doubled by 2008, to $13,000, hyper-inflation was brought under control, and the share of the population living below the poverty line was slashed from near 50% to around 10% today.

Over the same period, Argentina's economy grew by less than 40% to $11,000 per capita, and the sorry excuse for an economy run by the fearless leader of the Bolivarian Revolution, Hugo Chavez, didn't grow at all. Today, the order is reversed, and Chile leads the economic pack, with Venezuela bringing up the rear.

During this time, as the Cato Institute's Dan Mitchell notes in a blog post that cites Maddison's data, Chile's ranking in the Fraser Institute's Economic Freedom of the World Index rose from 5.6 (out of 10) in 1980 to an astonishing 8.0 in 2008, placing it solidly in the global top ten.

By contrast, South Africa is on a downward trend and ranks a dismal 87th out of 141 countries, with an economic freedom score that rose from 5.53 (out of 10) in 1980 to 6.74 in 2007, but dropped to 6.64 in 2009, the most recent year for which data are available.

As Neil Emerick, a council member of the Free Market Foundation, points out in his foreword to the South African edition of the report, more economic freedom creates longer, healthier lives and higher levels of income, and statistical correlation shows clearly the differences in outcomes between countries that have implemented successful policies and those that continue to increase the role of their governments to the detriment of their citizens.

For one more example, let's consider Estonia. It ranks 15th on the economic freedom index, and is notable for having the purest form of flat tax. It levies the same rate on every form of income, including both corporate earnings and personal income. It was introduced in the year 2000 at 26%, but has since been gradually reduced to 21% today. Whereas most of us spend hours, or even days, filling in complicated tax returns, often paying specialists to figure it all out, Estonians do it at their computer in 15 minutes. The result? Foreign investment quadrupled from 5% to 20% of GDP, and GDP per capita has doubled, resulting in higher government tax revenue despite a declining tax rate. Its economic growth rate before the global economy collapsed averaged 7.2% per year, and despite disastrous years in 2008 and 2009, which saw contractions of -3.6% and -13.9%, it still boasts a 3.6% average between 2000 and 2010.

By contrast, South Africa averaged 3.6% growth for the good years up to 2007, equal to Estonia's remaining average growth after its calamitous crash.

It is in light of these examples that we should consider finance minister Pravin Gordhan's announcement that he would replace the 10% secondary tax on companies (an explicit double tax) with a 15% dividend tax (an implicit double tax that is merely a lot higher), and the rise in capital gains tax from 10% to 13.3% for individuals, and from 14% to 18.6% for companies.

Remember that companies are already taxed on earnings to the tune of 28%, which is equivalent to the effective tax rate paid by an individual earning R520,000 a year. When companies determine that they're unable to use those earnings efficiently, and return them to investors to place elsewhere, the taxes on dividends or capital gains amount to double taxation that take the effective tax rate up to 38.8%. You'd have to earn an astonishing R5-million a year to reach that effective tax rate as a salary earner.

The consequences of taxing capital formation are many.

For a start, companies are more likely to retain earnings and reinvest them, even if such investments are not as profitable as others that the shareholders might have preferred. This harms the economy by misallocating capital.

Secondly, investors are able to place their capital anywhere in the world they feel they can earn a decent return. Confiscating a large chunk of potential returns discourages long-term fixed investment and makes South Africa an uncompetitive destination for capital. This is why South Africa so often looks like a small-time playground for short-term speculators, and why those who have created some capital so often go to great lengths to move their hard-earned returns to safer havens.

More generally, taxing something discourages it. You tax smoking or drinking when you want less of it. Let's stipulate that some form of tax is necessary to pay for (and reconstruct long-neglected) basic services. A low, fair income tax, or even a flat tax like in Hong Kong or Estonia, can achieve that without distorting the economy too much. But why would South Africa want to discourage capital formation? Why tax those who take successful risks? So we can subsidise those who take unsuccessful risks? In what economic theory does it make sense to reward failure, which makes everyone poorer, and punish success, which makes us all richer?

Encouraging economic growth above all else is a policy that will improve the living standards of South Africans, increase employment levels, and raise government revenue. Like in post-war Hong Kong, all growth in infrastructure and welfare spending can be funded by an economic growing at a healthy clip, even in the face of low tax rates.

Instead, South Africans are taxed when they earn money, taxed when they spend it, taxed when they save it, taxed when they invest it, taxed when they give it away, and taxed when they die before they get to do any of those things.

That poorer people – like small-time savers and pension-fund investors – are excluded from these draconian taxes, in the hope that it will encourage them to save, is an admission that they are bad for the economy.

It is no surprise Gordhan has to be satisfied with 2.7% growth, when sub-Saharan Africa is expected to grow at 5.5% in 2012 – twice our rate. The global average is 3.3%, dragged down by the negative growth in the eurozone (of which Estonia was a victim). Meanwhile, the Asian economies, which have long had Hong Kong as an example and benchmark, steam ahead at 7.3%.

Note how Gordhan cleverly mentioned these statistics in different parts of his budget speech, so we wouldn't notice and go, "What? Why?"

If we align ourselves with "most other countries", we shouldn't expect more than 3.3% growth. We shouldn't expect to rank in the first half of the economic freedom of the world index. We shouldn't expect prosperity and low unemployment.

We should be emulating the exceptional few, like Hong Kong, Chile and Estonia, who started with nothing, but dragged themselves out of the misery of World War II, Marxist socialism, and Soviet communism respectively, to achieve great economic success in a generation.

It's time we set out our stall to the world, and tempt them with low taxes and trade barriers, and a light regulatory touch. If they want to take their profits back home, let them. If they're free enough to do so, South Africa will be free enough for them not to want to do so.

When nervous investors scour the globe for the rarity of a sound investment, they shouldn't find a South Africa in line with "most other countries". That gives them no reason to come here other than the weather and the Big Four And A Few.

They should find a South Africa that is a startling exception to the dismal reality of socialist policies, corrupt officials, high trade barriers, confiscatory taxes and labyrinthine regulations.

We need the kind of tax reform that repeals the lot, and replaces it with a single number. I'm sure Sars has better stats than I do to work out exactly what it will take to cover the 2012 budget with a flat tax for all personal and corporate income above a given minimum, but it can't be much different from Estonia's radical post-Soviet experiment.

Let's build a tax code for an exceptional country, not one that is merely in line with "most other countries". **DM**

Correction: An earlier version of this column stated that companies are taxed 28% on revenue. They are, of course, taxed on earnings. Apologies for this rather silly mistake.