

## Some considerations for Australia's Taxation System within the context of overall Australian Governance

### Summary

The following undertakes an economic and empirical analysis of the tax system and its impacts on Australian society. The outcomes of the analysis are:

1. Globally there is a dearth of capital investment opportunities available for the very large capital pools currently under-deployed
2. There is no requirement to provide a tax incentive through lower capital and/or business taxes to attract capital to productive investments in Australian projects
3. Lowering capital and corporate taxes provides a counter-productive imposte on a medium sized open economy (like Australia) through greater extraction of rents from the national value chains
4. The race-to-the-bottom reduction in corporate and capital taxes reduces revenue to the government and does not attract increased capital investment
5. Historically neo-classical economic policies have resulted in reduced economic growth as opposed to classical Keynesian policy approaches
6. Highly foreign owned ventures which are captured by location of the primary resources will drive down contribution to the local economy which can only be countered through increased corporate and capital taxes
7. Economic growth is fuelled by the distribution of discretionary expenditure to a large number of purchasers. Economies with greater return to capital and reducing return to labour/expertise must respond through re-distribution funded through higher capital and corporate taxes. Otherwise demand reduction provides recessive pressure on the economy.
8. Indirect tax base expansion would point to introduction of a Financial Transactions Tax which may fund a reduction in the regressive GST.
9. Speculation should be discouraged and investment in productive ventures encouraged. Taxation can be used to encourage the stickiness of capital to disincentivise speculation without discouraging productive investment. Once again a Financial Transactions Tax is a known effective method of achieving this.
10. Income tax bracket creep is regressive and should be responded to via incrementing brackets and funded through creation of higher brackets with high taxation levels (as per Australia/US/UK etc during their highest growth periods immediately post WWII).
11. Innovation is only possible if the majority of economic enrichment of individuals comes from reward from personal innovation, endeavour and entrepreneurship. If inheritance is the primary mode of personal enrichment then innovation is disincentivised, leading to less economic progress in the economy. A "large estates" tax will discourage this drag on innovation. Alternatively a wealth tax (see Piketty) may achieve similar outcomes.
12. Tax is a government policy instrument that should not be considered in isolation of all other policy instruments. Economic efficiency is only one goal of an effective taxation system. The tax system must be compatible and synchronised with the entire portfolio of government policy goals (see Popova-Clark, 2011, submission to the Tax Forum)

## Race to the Bottom

There is a problem of “race to the bottom” on capital gains and corporate taxes when assessing the value of decreasing corporate and capital taxes to attract increased investment. Once one country begins to decrease taxes on capital in order to attract a greater share of the overall global investment capital pool, then other nations will have increased incentive to do the same. If many nations follow suit, eventually the global capital supply curve will move upwards, demanding greater return for the same level of capital. The original nation’s “competitive advantage” is lost and a further cut will be required to achieve the same end. Overall this decreases the supply curve of global capital funds (i.e. more capital return is required to attract the same volume of investment, the standard orientation for a supply-demand diagram) creating an overall deadweight on the global economy as more profit is extracted out of the global economy. So overall the “race to the bottom” cycle of tit-for-tat corporate and capital tax cuts only results in lower revenue for all governments globally.

## Profit is a cost

Profit is not the goal of an economy; it is the price an economy pays to provide a profit incentive. A profit incentive is needed for two reasons: 1. To attract sufficient startup capital to projects to allow them to begin operating prior to becoming self sufficient from a cash flow perspective and 2. To provide ongoing incentive for management to continually find efficiencies and eliminate waste in ongoing enterprises. This second part provides greater innovation, industriousness and management diligence to an economy.

However profit itself is an efficiency cost to the economy and must be minimised. It is a necessary part of a capitalist economy, due to the need for the profit incentive, but it is, nevertheless, a cost to be minimised. A profit efficient economy provides returns that are sufficient to both attract the necessary level of capital and to incentivise management to find operational efficiencies, but at the minimum level of profit returns. Assessing capital and management incentive as supply resources for which an economy would be willing to pay, the balance is achieved when supply of capital and demand for capital curves cross.

Across the world (and within each nation) there is a distribution of potential capital-requiring startup projects. Presuming there is insufficient capital for all potential projects<sup>1</sup>, then capital will first go to projects with the highest expected return (net of taxes) and then the next highest and so on until there is no further investment capital available. Only those with the lowest expected capital returns will go unfunded and therefore unexploited. In this manner, if all goes well, capital flows to the highest value projects first providing maximum returns to the economy.

Projects with extraordinary returns *need only provide sufficient returns to obtain funding*; not more. There is no benefit to the project or to the economy to provide greater capital return than is necessary to attract the required capital. In fact, in a perfectly efficient capital market, all funded projects should only provide the same capital return as the funded project with the lowest capital return. Where else is the capital going to go if there are no potential projects with higher capital return available? Secondly, there is no incentive for a project to offer greater capital return if it already has sufficient capital to exploit its economic opportunity (unless there is some form of market failure).

Profit inefficient economies with failed capital markets will overpay capital and/or over incentivise management for finding operational efficiencies. An example is reducing the

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<sup>1</sup> If there was enough capital for all potential projects the supply curve would be so low that capital returns need only be marginally ahead of 0% expected return to fund all projects

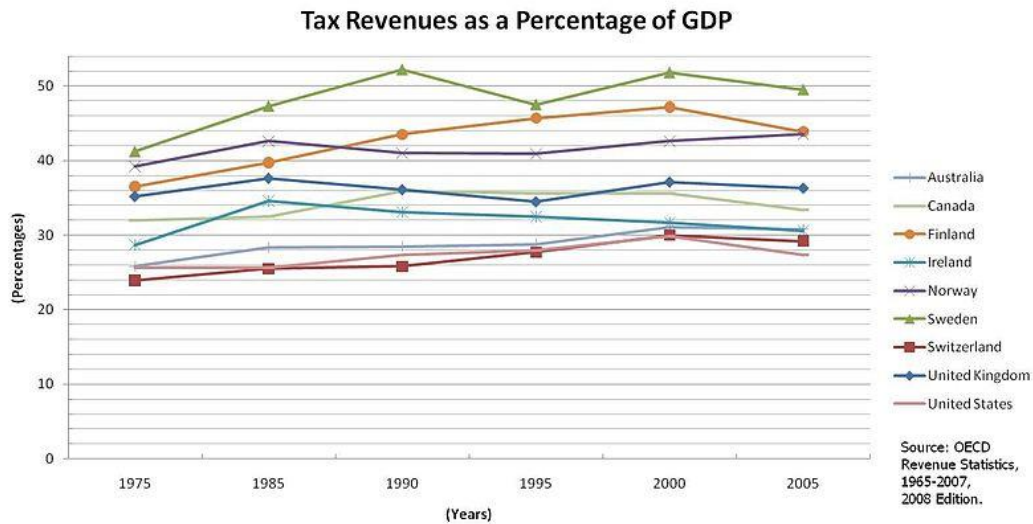
tax on capital returns in order to attract further capital. Does it work? Imagine that each country's economy has a portfolio of startup projects which offer varying potential rates of capital return.

Neoclassical economic theory is that decreasing tax on capital will lead to increased capital supply ( $V^1$ ) and therefore greater economic development (Atkeson, Chari & Kehoe, 1999). However, when we decrease the tax on capital to basically increase the demand curve ( $D^1$ ) for capital, we are moving the equilibrium point on return on capital upwards as well. Therefore, in order to attract more capital ( $V^1$ ) all projects that would have been funded originally will now also have to pay a higher capital return ( $R^1$ : net of tax) as well. This is an outcome to be avoided, as return on capital is an incentive impost to the economy. In addition, the amount of extra funds invested may only be a fraction of the increased capital returns paid by the economy for all projects. Moreover, the extra funding attracted will only be for those marginal projects that are of the lowest economic value.

This is the effect of decreasing corporate and capital tax: (i) attracting capital for only the most marginal projects, (ii) increasing the profit impost on all projects in the economy and (iii) thirdly decreasing revenue to government. Decreasing corporate tax should only occur when there is significant evidence that projects with high local value add (i.e. high local employment, increased local tax generation, use of profitable local suppliers) are not attracting funding and that decreasing the tax will reverse this situation. In addition, the impact on all other projects in the economy should be reviewed in terms of the impact on the expectation of capital return from investors. It is unlikely in this capital flooded global economy, that high value add Australian projects are unable to obtain the required investment.

## Neo-classical Ireland v Keynesian Scandinavia

Two extreme empirical case studies that illustrate the above analysis are the Scandinavian countries as against Ireland. The Scandinavians have generally maintained high capital, wealth, income and corporate taxes (around 45% -50% of GDP) compared to OECD averages whereas the Irish undertook drastic reductions in corporate (currently 12.5% statutory), capital (down to 20% until 2008) and wealth taxes throughout the 90s (overall tax is around 30% of GDP). For a short time Ireland produced spectacular GDP growth and foreign capital investment (Dorgan, 2006). However, government services and infrastructure spending were slashed to make up for the decreased government revenue. Due to the influx of foreign capital and the attraction of large corporate headquarters in Dublin, property speculation became rife. Other countries followed Ireland on a "race to the bottom" with their own corporate and capital tax cuts (particularly the Netherlands) and Ireland responded with a second wave of tax cuts (by this point the property bubble was allowing significant capital gain revenue to fund these cuts). However, the lack of actual economic value generated by actual national productivity increases (capital increases were being funded by speculative capital inflows), the lack of domestic capture of the large quantities of capital flowing through the country, the underinvestment in public economic infrastructure, heavy reliance on speculative capital and the global financial crisis, led to the entire edifice coming crumbling down in 2008. Many Irish property values are up to 50% below their last sale price with significant proportions of mortgage holders underwater (O'Carroll, 2011). Government revenue is severely down and the GNP has plummeted (-5% in 2008 and -11% in 2009). Government debt is well above 50% of Ireland's GDP which is more of an issue for a low tax state. Un-employment, at below 5% for almost a decade, rose to over 13% in 2010 (ESRI, 2011).



The Scandinavians meanwhile have quietly ignored neo-classical economics and continued with theoretically anti-competitive capital and income tax rates. Their tax rates currently hover around 50% of GDP (compared to Ireland's 30%). The result has been significant government investment in public infrastructure including roads, rail, water transport, alternative energy, education, health and social security. The Scandinavian countries continue to head many quality of life indicators amongst OECD nations on measures like crimes against the person, life expectancy, life satisfaction, abortion rates, equality of opportunity, social mobility, innovation, education, incarceration rates, bankruptcies etc etc (e.g. UN Human Development Index in Klugman, 2010; Wilkinson & Pickett, 2009). Meanwhile both Norway and Sweden rank amongst the most successful capitalist economies in the world with equity investors receiving exceptionally high levels of capital returns over the last 10 years, exceeding capital returns to investors in equities from the US, the UK, Germany, Canada, Japan, Ireland, Switzerland and even Australia (Credit Suisse 2010 Annual Report).

The key note for the above analysis (and supporting case studies) is the destruction of the presupposed dichotomy between efficiency and equity of distribution (described by Okun, 1975; Pressman, 2005). Once the character of profit (or capital return) is understood to be an impost/cost to the economy then its minimisation not only increases distributional equity but *also* increases economic efficiency. Profit is certainly something which has not been minimised in neo-classical economic work to date (unsurprising given the predominantly pro-profit corporate source of most neo-classical economics research funding in recent decades – Beck, Bolt & Ferguson, 2010).

## Concept of Economic Value Capture through Corporate Taxes

From the perspective of a national government, profit for corporations which are majority foreign owned is economic value lost to the nation's economy. Highly profitable foreign owned enterprises are extracting more from the national value chain and exporting it to foreign investors. The returns to the local economy of value chains are (i) wages, (ii) revenues of local suppliers, (iii) returns to local investors and (iv) government tax and charges revenues. Some corporations heavily automate processes, export profits and minimise the use of local suppliers. This means that little of the productivity developed by the local value chain stays within the local community. In such circumstances the government should consider charging hefty capital and/or corporate profit taxes to capture as much of the value chain within Australia as possible.

## Other Tax Revenue Considerations

Capital and Corporate tax cuts decrease government revenue which decreases public infrastructure investment (e.g. roads, rail, ports, electricity/power, water, healthy and educated/skilled labour). These public goods are then less available for all privately funded projects as compared to what would be possible with higher levels of capital and corporate taxation.

A still further problem is the initial assumption of insufficient capital for all economically valuable projects. In Australia, there is little empirical evidence that economically valuable projects are struggling to obtain capital investment (Reserve Bank of Australia (RBA), 2011). According to this economic analysis, governments should continue to increase tax on capital to decrease the return on capital (with reinvestment into productivity enhancing infrastructure – assuming unemployment above minimum) until there is evidence that the decreased return on capital is affecting the availability of capital for economically valuable startup projects. Retained earnings are at record levels in Australia (RBA, 2011) and in a number of Australia's trading partners. Many companies can fund new investments themselves and capital is beginning to find difficulty detecting new deployment opportunities. All of these circumstances point to requiring an increase in capital taxes, not a decrease.

It is difficult to distinguish between speculative capital and productive capital (Stiglitz, 2000). If easily distinguished, capital taxes could be minimised on productive capital investment (e.g. purchase of plant and equipment) and increased on speculative capital investment (e.g. stock market equities and derivatives) (Stiglitz, 1989). However given that it is problematic<sup>2</sup> to distinguish between speculative and productive incentive, it is counter-productive to decrease capital taxes as it increases the economic cost of returns on all investments; both productive and speculative. However, if there is an overt distinguishing characteristic between speculative and productive investment it would be the duration of capital investment (long: productive v short: speculative) and the required size of return (larger: productive v small: speculative). Increasing capital and profit taxes increases the required return and lengthens the duration of investment, thereby actively discouraging damaging speculative investment. As a greater and greater proportion of investments move into speculative investment types, then increasing capital return (through decreasing capital tax) merely extracts a greater and greater impost upon the productive economy for non-productive speculative capital (Keynes, 1936). The Empirical evidence of a growing amount of speculative capital, such as we have today, requires a response of increasing capital and profit taxes to decrease the overall cost of capital.

## Use of Tobin Tax to Stymie Speculative Investment

A key issue with modern capital markets is the problem of frequent asset price bubbles. This is caused when excess capital is used as a speculative investment over and above what is justified from the expected future returns expected to be generated by the investment. Indeed the major justification for buyers in an asset bubble market is the concept that there will be another buyer in the near future who will be willing to part with yet more capital to own the inflated asset. This can be property, shares, commodities or even tulips. Asset bubbles are characterised by rapid change of ownership and capital flows. A Tobin-like tax on all financial transaction tax will act as a brake on rapid counterproductive speculative capital flows, leaving only the slower productive investments profitable for the capital investor.

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<sup>2</sup> It has been suggested that a Tobin tax on foreign currency exchange transactions might shield a small open economy from the worst of speculative short-term capital movements - Tobin, 1972

Another imposte on markets is the incessant extraction of small percentages from markets by rapid algorithm based computer trading, market makers and by day traders who trade on small market movements. A Tobin tax will decrease the profitability of these small parasitic financial behaviours, leaving the markets to fully reward productive investment.

Profit, like social security, is a cost on society with no productive value in and of itself. Profit does facilitate the functioning of the economic and social systems. Profit must be paid from the economy to attract capital and to provide a profit incentive. Social security is required to ensure that the minimal standards of health, nutrition and housing are available to all citizens such that they don't turn to economically destructive activity to survive (e.g. burglary, mugging, kidnapping, theft etc). However, both costs must be minimised. Over remuneration of profit disincentivises wealthy capital investors from contributing productively to society through productive industry, labour, and innovation. Oversupply of social security will similarly disincentivise holders of labour resources (i.e. workers). Government policy should target minimum necessary economic output diverted to the imposts of both profit and of social security.

## **Moral imperative to tax the wealthy more**

There are multiple reasons why the wealthy should be taxed more than others:

1. The economic system of capitalism is a winner-takes-all system (Frank, RH and Cook, PJ (1993). Capitalism tends to magnify the losses and rewards for slight differences in economic value add, due to the return on risk. In addition there are still enormous market deficiencies within Australia's and its trading partners' economic systems: monopolies (artificial and natural), cartels, artificial regulatory barriers to market entry, tragedy of the commons, information/expertise imbalance between transacting parties, externalities, human irrationality, executive dominance of corporate boards, speculation etc. These market imperfections tend to magnify the concentration of wealth to corporations and wealthy individuals beyond their actual contribution to the value in society. Government can correct these market imperfections through progressive taxation of excessive income and capital returns.

2. All value is generated using the infrastructure inherited from the past (McQuaig and Brooks, 2010). Bill Gates could not have developed MS-DOS and Windows if there had been no computer upon which to deploy the software. Computers, in turn, could not have been developed and deployed without a ubiquitous electricity infrastructure with which to power these devices. All value generating activity is largely dependent upon the current and previous public infrastructure that exists for it to operate within (Brooks, 2010). Individuals that are generating enormous personal gains are relying more heavily upon the pre-existing and current public infrastructure for their gains than those who are receiving less and therefore should contribute more back to society.

3. Wealthy individuals have more to lose from a breakdown of society than those who are not receiving as much of its benefits. In order to protect their current privileged position (regardless of how it was attained) the wealthy should be willing to invest a greater proportion of their wealth toward the protection of civil order and societal maintenance than those who would lose little from societal breakdown. For instance, social welfare programs decrease the incidence of economically motivated crime like theft, burglary, mugging etc (Weatherburn and Lind, 1999). The wealthy also benefit more from the maintenance of the current governmental system. A strong defence force maintains the integrity of their host nation, but does so at a cost that the wealthy should pay more for.

4. Human rights, generally accepted by most modern nations accept that all humans have innate human rights. Fundamental rights like the right to breathable air, drinkable water, minimum levels of basic nutritious food, personal security and minimum standards of sanitation and health are considered to be non-discretionary expenditure whereas luxuries and non-essentials are considered to be discretionary. If society is taxing those whose income is not sufficient to purchase fundamental rights (food, water, health etc) in order to leave others with more discretionary income for luxuries, then its priorities can be questioned.

5. As identified by the Carter Commission, wants and needs have a different moral imperative (Warren, 1988). The majority of a poor person's economic resources may be deployed toward the attainment of survival needs with very little left for wants and desires. They have little discretionary wealth. The rich however have significant discretionary wealth with which to purchase further utility above and beyond absolute need. It would be unethical to extract some of the resources required for basic necessities from a poor person, when a rich person with significant remaining discretionary resource could instead be taxed further. Essentially government should not tax someone to starvation so that another can continue to consume their caviar, regardless of the caviar eater's contribution to society.

6. Another issue to consider is the issue of guarding against the over-concentration of wealth in a democratic political system. Extreme wealth disparity within a capitalist democracy results in the concentration of media and political influence into the hands of a relatively small number of wealthy individuals (Winters and Page, 2010; Jacobs & Page, 2005). Democracy relies on the relatively equal sharing of political power across a large number of interests. Extreme concentration of political influence is antithetical to a functioning democracy. A key mitigation for preventing over-concentration of wealth is high taxation of extreme wealth and/or extreme wealth transfer (Brooks, 2010).

7. Early work in Behavioural Economics research shows that almost all Americans of all incomes and political persuasions prefer much greater wealth equality than is the actual case within society (Ariely & Norton, 2010). Even high income Republican (Republicans are the US equivalent to the Australian Liberals) subjects felt that a wealth distribution more closely resembling Sweden's was preferable to the actual current distribution of wealth within the US. It is likely similar findings would be found in Australia.

## **Implications for Tax levels on Capital and Wealth**

We have established that cutting capital and wealth taxes is counterproductive for both efficiency and equity within a capitalist economy unless there is evidence of underfunding of economically valuable projects. We have also established that tax increases should preferentially be targeted towards those with most discretionary capital and income: the wealthy.

A democratic government must correct market weaknesses through regulation and wealth re-distribution. Additionally, democracy itself is vulnerable to extreme wealth concentration (Popova-Clark, 2011). In order to preserve the integrity of the democratic capitalist based society enjoyed by most OECD nations, governments must:

1. Ensure that extreme wealth concentration is prevented
2. Redistribute wealth to ensure that: (a) as few citizens are incentivised to undertake criminal activity in order to obtain the basics necessities of modern life as possible, (b) that excessive over-reward for effort and unearned windfalls are corrected and (c) ensure fair return for contribution

3. Undertake the above in such a way that the key incentives encouraging industriousness, entrepreneurship and innovation remain intact for as great a proportion of the population as possible
4. Identify and correct any key market failures such as externalities and monopoly

Key tools in the kit-bag of modern democratic governments operating within capitalist economies include:

1. A progressive tax system overall by making progressive elements of the system excessively progressive to adjust for the proportional and regressive aspects of other components of the tax and transfer systems (e.g. State Taxes, consumption taxes)
2. Prevention of excessive unearned windfall gains through gift, and bequest/estate taxes
3. A rent upon large accumulations of wealth under the control of individuals through progressive wealth taxes, property taxes, corporate taxes and capital gain taxes
4. Redistribution of wealth to the less wealthy through social security (which can be purpose targeted based on need and carefully administered to maintain work incentives)
5. Placing caps on tax advantaged system like super and housing (e.g. capping the main residence exemption at an inflation adjusted \$2M value – i.e. ignoring all residence value above \$2M, super contribution caps)
6. Progressive taxation of property holdings (e.g. land) for individuals

## Conclusion

The taxation of non-labour income (ie. Arising from ownership of Capital and Property) and wealth was treated from a relatively narrow tax theoretical basis by the Henry Review. Many fundamental issues such as wealth inequality, appropriate savings rates of households and inequitable political and media influence were left unmentioned. As a result the tax responses (particularly wealth taxes) that would seem to be a primary response available to government are left unassessed by Australia's most recent major tax review (Brooks, 2010, Piketty, 2013).

The ideas that (i) profit is an economic impost, (ii) capital tax decreases will normally decrease the efficiency of an economy (by increasing profit), (iii) Okun's efficiency vs equity dichotomy is empirically illusory and that (iv) the tax and transfer system is just one part of an overall portfolio of policy levers available to democratic governments operating within a capitalist economy (all fundamental issues to a comprehensive tax system assessment), should be assessed against Australia's Tax and Transfer system before further tax changes are undertaken.

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