SUBMISSION TO THE PRODUCTIVITY COMMISSION
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PILLAR ONE
CREATING A DYNAMIC AND RESILIENT ECONOMY

Corporate tax reform to spur business investment

Introduction

The Interim Report jumps straight into recommending a so-called cash flow tax. The name cash flow tax seems to stem from a recommendation by Ross Garnaut et al (2020) who was recommending the Meade Cash Flow Tax recommended by Meade (1978). Garnaut et al implies that a cash flow tax is a tax on economic rents. It is not.

This Meade Report was the last hurrah of non-mathematical economists, and as a consequence no attempt was made to prove mathematically that the R base, or the R + F base was any way neutral, aside from Meade's unsupported statement based on his prestige as a professor of economics at Oxford, that these cash flows taxes were neutral. Meade proposed that this net revenue tax is a tax on economic rents. We shall call the Meade definition the Meade Tax.

Meade divided the tax base in into an R base, and a R + F base. What Meade proposed is that you could have an R tax, being the tax on the net of all Real receipts and payments on physical goods, or an R+F tax, which includes all Financial inflows and outflows in the net tax base. You tax the net position. That is the Meade tax base.

Note that in the Meade Tax, interest payments are deductible from the tax base.

The alternative proposed tax on economic rents, precisely defined mathematically, is the so-called Brown Tax, defined by E. Cary Brown (1948). The major difference between the Brown Tax and that the Meade Tax, is that the Meade Tax base is <u>all</u> revenue minus <u>all</u> expenses, (that is net cash flow); in the Brown Tax base interest payments are NOT deductible from revenues. Thus, unlike in the Meade Tax, in the Brown Tax you do NOT tax <u>all net</u> revenues in order to tax economic rents. (For clarity there is a formula for the Brown Tax on page 3).

What finally scuppers the Meade Tax is the claim by Meade that cash flow taxes, either a R or a R+F tax, do not distort the choice between debt and equity financing, and therefore it must be neutral and a tax on economic rents. Yes, the claim sounds nice, but it is just a verbal claim. In actual fact, while equity financing is neutral, debt financing is not. This is demonstrated mathematically in Note 3 of my book, “Taxing Economic Rents 2nd Edition”. The Meade Tax is not neutral and is not a tax on economic rents.

Garnaut et al (2020) seem to have initially made a mistake when calling for a Meade cash flow tax as tax on economic rents. Yet they continued this recommendation with an economically sensible proposal that the tax system should move to a tax on economic rents, or the Brown Tax. The Brown Tax is not at all a tax on only cash flows. That is, solely a tax on net total income less expenditure, and should not be called a cash flow tax. It has a specific structure in order to gain neutrality. Unlike the vague claims of cash flow neutrality of the Meade Tax, the major component of the tax base of the Brown Tax is that interest payments are NOT deductible from revenue. In the Meade Tax interest payments are deductible from revenue.

The Meade Tax, being a tax on net cash flow, is NOT neutral, as it allows the deduction of interest payments from the tax base. The Brown Tax IS neutral as it does not allow the deduction of interest payments from the tax base.

As the Meade Tax allows the deduction of interest payments from the tax base it subsidises borrowing and so any expenditure funded by borrowing such as capital expenditure. This may encourage faster growth. But I do not feel that any subsidy is a good idea as it distorts decision making.

The Tax on Economic Rents

In 2016 wrote a book on this subject titled “Taxing Economic Rents”, and extended this book in 2020 by publishing “Taxing Economic Rents 2nd Edition”.

Anyway, a quick survey of my books is as follows:

This description is based on “Taxing Economic Rents 2nd Edition”, which contains a very useful introduction of the whole field, including land taxes and extending the economic rent tax to employment income. It also indicates that for Banks and other financial institutions a tax is neutral when it is a Brown Tax modified by deducting the value of interest paid from the interest received (actually on the same loan, but in practice in total over a certain period). Also, it points to a proof that capital raising, using debt, as against capital raising, using equity, is non-neutral; and also shows a proof that long term lending is less profitable to the lender than short term lending.

The book starts with a definition of economic rents. It is “return over and above opportunity costs or the normal return necessary to keep a resource in current use”.

The book then goes onto the cause of economic rents. It is not just monopolies and trade restrictions as frequently claimed, but market failures in general. Market failure is always with us, and are NOT just due to monopolies and market restrictions. These many continuing market failures are the reasons for the continued existence of economic rents, and these economic rents can be taxed.

The book contains a definition of the Brown Tax - the tax on economic rents. As explained, the Brown Tax is NOT just a tax on corporations, but can be a tax on <u>all</u> businesses, including single person businesses, including professional practises and trades.

The Brown Tax formula is:

$$\boldsymbol{\sigma = R - (E - i) - C}$$

Where
$\boldsymbol{\sigma}$ is the value of economic rent
R is total revenue
E is total current expenses
i is the interest paid by the business
C is total capital expenditure

Note that the interest paid by the business is NOT deductible.

This non-deductibility of interest payments will cause the galloping herd of lobbyists to pound up and down the corridors of Parliament House. So be it.

Does the requirement for 100% deprecation cost the government more compared to the spread-out depreciation under the present system? It does, but only by a small amount. It does not lose out on the total dollar cost of the depreciation. There is a small loss only due to the difference in present values of the depreciation.

If for example the current depreciation rate is 10 per cent per annum, there would be 10 depreciation deductions of 10 per cent of the total value of the capital purchase spread out over the coming ten years. The dollar cost of that depreciation over that 10 years to the government would be the same as the one 100 per cent depreciation in the first year. What the government would lose would be the difference in *present values* of these 10 per cent depreciations over the 10 years compared to the 100 per cent depreciation. The government gains slightly from the 10 per cent depreciation over ten years compared to the 100 per cent depreciation in the first year. Also, the government would of course gain from the inflation on the later depreciation deductions. There is also irrationality about the whole question of 100 per cent depreciation. What governments will say “There will be another government in ten year’s time. I will lose out now if I allow 100% depreciation, and the future government will gain from all the depreciation I have lost.” It is silly argument, but I have actually heard it. Nothing can be done about it.

In Chapter 19 there is a mathematical proof that the Brown Tax is neutral. I have yet to see this proof in your Reports, or indeed the published papers relating to this matter.

Chapter 20 is on taxing Banks, or taxing any financial institution that lends money for a profit for that matter. This subject has been a major lacuna on discussions on this question.

Yes, as you suggest in a few words (carefully hidden), an economic rent tax on <u>any</u> lending financial institution should be the Brown Tax adjusted for the difference in interest gained from lending and the interest paid in borrowing. Theoretically on that loan alone; but for practical reasons, the difference between interest receive and paid in a particular period.

The proof that this interest deduction is neutral for financial intermediaries is in Note 1.

Notes 2 and 3 discuss theoretical issues relating interest and economic rents, including that matter of the comparative neutrality of capital raising using debt or equity.

Dealing with carry forward losses.

This is a major political hang-up. In the Brown Tax the firm must receive a subsidy from the government for its losses as the losses occur, *if the losses cannot be offset by the firm's revenue.*

This concept of subsidy has raised concerns that the government would then be a "partner" in the firm. There is also talk about adverse incentive, encouraging the firm to take greater risk. Is the outcome truly neutral? Does this tax move the firm from being risk averse under the old income tax scheme to risk preferring under the Brown Tax scheme? My opinion is that the mathematics says that the outcome is neutral, but there has been a lot of water under this bridge in this discussion.

One cure for this discussion is that it can be shown that if the accumulated losses are carried forward until they are set against subsequent profits, the tax remains neutral. Interest on the amount carried forward is compounded against this amount.

There are two major issues with this proposal. The first is the nature of the interest used. The second is the question of uncertainty – that is, whether or not eventually revenue for the firm turns positive in the future. In academic discussion the interest rate is often taken as the government discount rate, and risk discount is added to this rate. (Boadway and Bruce (1979)). My opinion is that the carry forward discount rate should be the same interest rate as the firm borrows from the bank, as it contains an element of risk premium.

We have now dealt with the tax on economic rents for all business income, including that of professionals and sole traders. But the Brown Tax can be extended to Employment Income.

Employment Income.

Remember this is a tax on Economic Rents. Employee income contains economic rents also, and these economic rents can be taxed. Yes, the income of a hospital doctor is much higher than for a labourer for the reason it contains economic rents. All income above a basic wage can be defined as containing economic rents, and can be taxed by a tax on economic rents.

Since with employment income, in most instances, capital expenditure is not required; or if some capital expenditure is required, for some tools say, this expenditure is likely to be minimal.

This employment income economic rent tax is defined as rents obtained by employment income above a threshold of income where no economic rents are accrued in that particular activity.

This threshold income can be defined arbitrarily as a “basic wage” of the lowest paid worker, or it can be found empirically – a wage level at which no discernible economic rents area accrued.

This threshold wage level would be tax free. Anything above this threshold income would be taxed.

In a tax on economic rents of this sort the wide range of deductions currently allowed will not be allowed. No deductions will be allowed.

The tax rate can be progressive. Indeed, it will be progressive even with a flat tax rate because of the tax-free threshold.

Land value taxes

Land values produce pure economic rents as the supply of land is fixed. (This is basic economics – a vertical supply line). The method to tax economic rents on land was worked out by the brilliant economist, Henry George, in 1879. George divided land values into two components, unimproved land values and improved land values. You only tax the improved land values. (If you think that this sounds strange, just look at your home. This is how it is taxed. Yeah!)

Valuing the taxation of economic rents in Australia

In my book “Taxation of Economic Rents” I estimated the value of the tax on economic rent for corporations, business and personal income tax for the year 2012-13. I used the Australian Taxation Office (ATO) Tax Statistics for that year.

What I did was to go through the taxation statistics for corporations, businesses (partnerships and sole traders), and trusts (trusts are a form of business), and removed the deductions for interest payments.

For personal income, I taxed all personal income above a certain threshold income at a fixed rate.

I found that corporate taxation alone increased by 159%, sufficient to remove the GST, a wretched inefficient and regressive tax! If you include rent taxes on employment income at the same rate, the total tax increase would be 19%. Such a result is a clear indicator that employment income is over-taxed by the present income tax system, and corporations under-taxed, compared to a tax on economic rents.

Other theoretical Issues

The rest of the book discusses theoretical issues that are probably of no interest to the Productivity Commission. However, I draw attention to the concept of Excess Burden or Deadweight Loss. This is effectively a hidden tax on tax, and it increases with the inefficiency of a particular tax system. In my perception, currently no-one in Australia can estimate excess the value of excess burden on particular taxes, shown by the inaccurate statement going around, that the GST suffers from less excess burden compared to the income tax. More research needs to be done in this area in Australia. For a tax on economic rents, excess burden is zero.

Conclusion

In conclusion, if the government raises all its revenue, with the possible exception of certain excise taxes aimed at reducing consumption of certain commodities, with an economic rent tax (specifically a Brown Tax) the benefits would be:

a. vastly increased taxation revenue at a given tax rate
b. a greatly increased simplification of the tax system. I have not gone into the issue of tax evasion and avoidance, but a tax on economic rents would vastly reduce these activities (interest deductions is an open barn door on tax avoidance), if not remove them entirely.
c. The economic efficiency of the economy would be vastly improved as excess burden is eliminated. Economic growth rate will leap ahead. This is aside from productivity gains caused by the increased rate of investment.

DISCUSSION ON THE DRAFT RECOMMENDATIONS

Draft recommendation 1.1

“Pivot……Cash flow tax”. I have alluded to the inaccuracy of the term “Cash flow tax”. The use of this term is confusing as well as inaccurate. The implication is that the Productivity Commission is advocating a tax on cash flows. That is foolish.

What is the motive behind this obfuscation? It confuses things, and the end result is that you do not end up with a tax on economic rents.

Draft recommendation 1.2

Reduce the headline company tax rate to 20%

Yes, a reduction in the company tax rate is needed, if you look at our competitors. This relatively high rate encourages tax avoidance strategies, and a significant leakage of investment capital out of Australia. Despite a company tax rate of 30% appearing to provide increased revenue compared to one of 20%, the outcome for Australia as a whole, in terms of reduced growth and lower investment, leads to lower tax revenue. Effectively Australia company tax revenue is reduced. (Again, there should be more economic research into this matter. The paucity of economic research into this question, “Do higher taxes reduce tax revenue?” is very sad.)

Draft recommendation 1.3

Introduce a cash flow tax of 5%

Whether or not this accompanies a reduction in the company tax rate to 20%, this idea of a very limited introduction of a tax on economic rents is pathetic. What is its purpose? Is the idea to introduce a tax on economic rents under a false flag, and when its success becomes obvious, gradually increase it? Political fears botch all economic reforms. If have seen this happen with the Petroleum Resource Rental Tax.

The taxation system has a desperate need of fundamental reform, as it is directly responsible for the current situation of slow growth of the Australian economy. Do you know what a growth rate of 0.3% means? The economy becomes a zero-sum economy. At an 0.3% growth rate, given the rule of 72, the standard of living does not double for 240 years! It reduces the vast mass of the Australian population to peasantry. If somebody gains financially, it is the direct result of an equal loss of other people in the economy. The expectation that your children will be better off than you is gone. Australia is reduced to the economy of pre-eighteenth century Europe. In contrast, the growth rate in the previous few decades was about 3% per annum. The standard of living doubled every 24 years. One car, then two cars…

Will welfare help? No, of course that. If you increase someone's welfare, under zero growth you are reducing the welfare of somebody else. There is no "bag of wealth" to tax. Even printing money and borrowing is just a reduction in the standard of living of a section of the community, usually the poorest.

Whatever political side you are on, you need growth. There is no more to squeeze out of a no-growth economy. Increased taxes and extraction can only lead to economic collapse.

The situation is desperate indeed. Minor reforms won't make it. We have to shift to a high growth economy. Australia is an island, and can become a trading nation building and selling things we make here. We must do that. For that we need an efficient tax system that encourages growth. Plus of course all those other goodies – vastly improved infrastructure, wealth building education etc.

In ten years' time the need for a higher growth rate will become manifest. There will be a lot of political trouble. The present Inquiry does not exhibit any urgency on this question. This Inquiry appears to have been set up to fail.

Regulatory reform

I have not gone into the need for regulatory reform, but here are a few comments. Generally, my opinion is that reducing the number of regulations is a cost-free method of increasing growth, and should be encouraged.

Draft recommendation 2.1

Set a clear agenda for regulatory reform

I am fully in favour, but it looks like wishful thinking. The opposition, even inside the government administration, will be massive. No chance.

Draft recommendation 2.2

Bolster high-level scrutiny of regulation

The various planning bodies will resist any reduction in regulations. It will be like two dogs fighting over a bone. One dog will be the Office of Impact Analysis. The other dog will be one of the numerous bodies of regulators, or alternatively one of the bodies of land use "planners". The regulation will be the bone.

Since a reduction in the number and extent of regulations impacts on the size and income of the regulating body, the "bone" will be fought over with ferocity. I do not think the Office of Impact Analysis will have much success.

Draft recommendation 2.3

Enhancing regulatory practice to deliver growth, competition and innovation.

Another high-sounding expectation. Replace one regulation by another better one? Best of luck. This will require an economic framework. This will be a problem, because at the present time, even if there is support from the government, there is a shortage of capable economists in the public service, and fewer can be recruited, as fewer well qualified economists are graduating from Australian universities every year. The requirement to enhance regulatory practice looks like an impossible task.

On this matter I have a useful recommendation. A small sentence hidden away in the recommendations recommends that a "sunset date" be put on all regulations. When the sunset date of the regulation expires, the regulation expires automatically, and if the Regulator wishes to continue with this regulation it has to fight with the Office of Impact Regulation.

This process can be in the form of a public enquiry, where the regulated can have their say. As many regulations are otiose, there may not be a great resistance to their expiry.

Nothing has been said about the process of the creation of regulations. The process is too easy. While ostensibly all regulations have to be approved by the Senate, in practice there is little or not supervision. These regulations, proposed by various government bodies, go straight through, without even the regulated having a say, or even being informed.

There is a strong case for reforming the present system, and putting a number of hurdles in place. A public inquiry for each new regulation?

The Productivity Commission should at the very least, as part of this enquiry, publish in detail the entire regulatory process. At the moment, this process is shrouded in obscurity. Only a few insiders in the public service are aware of the process of generating new regulations.

Finally, as many economists know, many regulations benefit the regulated. They create economic rents. Regulations are sought by many as a form of "rent seeking". For example, medical specialists make an extra hundreds of thousands a year as a result of their profession being regulated.

THE FIVE PILLARS

This closing section discusses the mindset of this enquiry, in that the government is clearly not yet interested in growth. Nor are others in Australia, such as the Business Council. It will take another ten years of zero growth, by when Australians will clearly have become the poor whites of Asia, (we already have half the standard of living of Singapore), that minds will concentrate on this issue.

This lack of interest in growth is demonstrated by the “five pillars of wisdom”. These are:

- Creating a more dynamic and resilient economy.
- Building a skilled and adaptable workforce.
- Harnessing data and digital economies.
- Investing in cheaper, cleaner energy and net zero transformation
- Delivering quality care effectively

The first four are interconnected. The fifth, delivering quality care, has nothing to do with productivity and growth. The inclusion of this pillar demonstrates the lack of commitment of the government, and indeed everybody else, to the need for growth as a priority. Other priorities cannot supercede this overarching requirement for growth, and until this belief changes, growth will not occur.

I have discussed the major requirement of creating a more dynamic and resilient economy by introducing a tax on economic rents, not some half measure involving a so-called cash flow tax. The following three pillars are subsets of the first pillar, and I shall briefly discuss these in turn.

Building a skilled and adaptable workforce would be vastly improved in Australia by copying the German educational system in encouraging the majority of students to enter a greatly expanded Technical College system at the expense of Universities. This transfer can be achieved by increasing the price of non-technical education, including law, arts, and so on, and making technical education free.

Harnessing data and digital economies is already being well catered for by the large international IT companies. The current attention on AI does not mention what is on the near horizon – ROBOTS. The Australian mindset, “protect the workers” will resist the introduction of robots in Australia. Short term attempts to maintain employment in Australia will cause long term poverty, and as I said make Australians “The poor whites of Asia”. In a decade or so the increasing poverty of Australians will force the government to remove all restrictions against the introduction of robots. By that time Australia will be many years behind the competition.

Investing in cheaper, cleaner energy to achieve zero transformation is a politicised mess. The vast costs and inefficiencies incurred by this transformation will certainly drag the economy down and increase poverty in Australia.

On this question, I have an interest in nuclear fusion. Specifically head to head hydrogen plasma fusion. Firing two columns head to head of hydrogen plasma at high speeds to achieve hydrogen fusion in order to generate cheap electricity. I suggest that this will be the solution to achieving cheap energy that will be at the same time clean. The present Tokamak research is going nowhere, and is very expensive.

CONCLUSION

Increased economic growth per head is essential for all societies, especially Australia. Economic growth in Australia has fallen to a very low level. When this happens in any society, resources are limited and fixed, and the only way for a person to become better off is to make another poorer. Under these circumstances, if government welfare makes certain persons better off, it makes others poorer.

Currently growth is very low, and is not likely to increase in the foreseeable future. This will cause increasing poverty.

The only cure for this situation is higher growth. To achieve higher growth, it is necessary to make the economic system favourable for growth.

One of the factors favouring increased growth is a tax system that favours growth, by encouraging capital investment. Under the free enterprise system, entrepreneurs invest in new capital equipment to make money. New capital equipment is superior to older capital equipment because it incorporates new technology and is more economically efficient. In other words, it is more productive.

There are many measures of productivity, but increased productivity is necessary for growth. No productivity, no growth. And this increased productivity is caused by the investment in new machines.

There are other causes of increased national productivity such as increased and better education, better infrastructure, and better incentives. However, among these, the use of new and better machines and techniques are the major cause of increased productivity and growth.

More capital investment – more productivity – more growth.

These three factors are strongly connected. So how do you obtain more capital investment?

The government could of course subsidise capital investment. Or have a zero tax on capital investing business. But, given the need for government to raise revenue, there is a very efficient tax that encourages capital investment. The tax on economic rents – or the Brown Tax. This tax is just like a modern corporation tax, except the difference is that depreciation is 100% for all capital expenditure in the initial period, and there are no deductions of interest payments. Treatment of losses, if any, are a matter of discussion.

This tax on economic rents is technically efficient, and would greatly encourage capital expenditure, and thus growth. My calculations are also that it would increase revenue from the corporation tax.

Other parts were proposed in this Inquiry. These were discussed briefly, and suggestions made.

As said at the start of this conclusion, I hope that the government takes the need for growth seriously. Without increased growth, everybody suffers.

The draft recommendations were vague and half hearted. In the case of tax reform these draft recommendations forced the expanded Interim Report into technical errors on the concept of a so-called net cash flow tax. The politicised recommendations of having a dual corporate tax system were nonsense. The expanded report on regulation was little more than wishful thinking. It is clear that the government does not take the need for growth seriously enough – yet. When zero growth has continued for another ten years, people and the government at the time will be desperate. For every individual improvement in their standard of living, there will be an equal value fall in the standard of living of someone else, probably among the poorest and most economically weak. The economy will be a zero-sum game. Keynesian expenditure will just move wealth from one sector to another. With population growth there will be a fall in the standard of living per capita.

I hope all those responsible take this warning seriously. There must be a genuine enquiry into the causes of growth, and if these conclusions are correct, whether macro or micro, these goals must be pursued ruthlessly.

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