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**Submission on "Australia's Future Tax System".**

With responses to "Consultation questions" posted at
http://taxreview.treasury.gov.au/content/ConsultationPaper.aspx?doc=html/Publications/Papers/Consultation_Paper_Summary/index.htm

May 1st, 2009

**Q1.1** Two Key features are recommended:

1. Introduction of "Dynamic" property rights to reduce the need for taxes, reduce the number of welfare recipients, the cost of welfare and government administration by the innovative techniques described in my 1975 book *Democratising the Wealth of Nations* available at http://ssrn.com/abstract_id=1146062.

2. Introduction of a "Neutral" enterprise tax system to create a level playing field for allocating resources between corporations, partnerships, trusts, cooperatives and other types of entities.

Dynamic property rights

My book is based on the voluntary introduction of dynamic property rights through tax incentives. A core technique is presented in a scholarly refereed article selected for republishing with the seminal contributions of leading international scholars. Refer to 'Stakeholder Governance: A cybernetic and property rights analysis', in *Corporate Governance: The history of management thought*, R.I. Tricker, ed. pp. 401–13, Ashgate Publishing, London, based on a working paper at http://cog.kent.edu/lib/turnbull6/turnbull6.html. This writing provides a tax cost income benefit analysis of incentives to introduce Ownership Transfer Corporations (OTCs).

The apparent paradox of distributing more wealth with less tax arises because economic analysis assumes that property rights to assets are fixed and not a policy variable.

Dynamic property rights to widely distribute assets ownership can be introduced on a voluntary basis with appropriate tax policies. The Appendix in my 1975 book and the examples in my article referred to above show how investors can obtain larger, quicker less uncertain profits by transferring ownership to others through an OTC. Because the Present Value of future cash from asset ownership diminishes at a compound rate, relatively small incentives are required for the *voluntary* transfer assets an order of magnitude greater than the cost of the incentive.

A tax regime to make attractive the conversion of existing firms to OTCs would transfer the tax base from firms to individuals. This could result in more revenues being raised than were forgone while at the same time reducing the need for welfare support to individuals. As welfare recipients do not have an opportunity cost to discount the value of future cash, a win-win result can be achieved for both firms and welfare recipients while increasing tax revenues and reducing the number of eligible recipients and government administrative costs. The latter objectives are achieved because wealth transfers are privatised through dynamic private property rights.

The former objectives are achieved because economic analysis does not recognise how investors can get overpaid with profits in excess of the incentive to invest. These "surplus profits" are not reported by accountants and so not noticed by economist's who confuse the concept of surplus profits with 'economic rents" which **are** reported by accountants. This confusion is explained more fully in my refereed paper: 'Grounding economics in commercial reality: A cash-flow paradigm', in Kreisler, P., Johnson, M. and Lodewijks, J. (Eds.), *Essays in Heterodox Economics: Proceedings, refereed papers, Fifth conference of Heterodox Economics*, University of New South Wales, Australia, pp. 438-61, 2006, http://ssrn.com/abstract=946033.

Ownership transfer of any corporate assets for which the tax payer obtains a tax deduction for depreciation or depletion should be required to be transferred to an employee trust at the same rate the assets is written-off. This policy would not result in reducing reported profits. It would reduce the over-payment of investors with surplus profits. This policy should be immediately introduced as a condition for any corporation that obtains government financial support as has recently provided in the automobile industry, banks, textiles, child care centres and other businesses. Ownership transfer in this way should also be included as a condition for foreign investment. The writer submitted these ownership transfer policies to the Assistant Treasury, The Hon Chris Bowen as the Vice President of the Australian Employee Ownership Association in an AEOA delegation meeting with him on Thursday, April 30th, 2009. The AEOA submission of May 1st develops further details of this proposal.

Dynamic property rights can also be used to create eight ways for democratising the wealth of cities as explained in my paper, 'Limitations in orthodox economic analysis of urban realty' presented to the 10th Anniversary Conference of Association for Heterodox Economics, Anglia Ruskin University, Cambridge, 4, July, 2008, http://papers.ssrn.com/abstract_id=1113603.

## Neutral Enterprise Tax System

A neutral enterprise tax system is one that treats all enterprises the same way independently of their legal form. This option was not considered by the 1975 Taxation Review (Asprey Committee) as noted in my attached article 'A Neutral Enterprise Tax System' published by the Securities Institute of Australia in June, 1979 on pages 22 to 23 of *JASSA*, No.2.

The benefits of a neutral enterprise tax system are that it:

(a) Creates a level playing field for allocating resources between different legal forms of enterprises;
(b) Eliminates double taxation of profits and so the need for dividend imputation;
(c) Substantially increases the efficiency of the capital markets as the decision on where to re-invest profits is made by investors who (i) have many more options than the enterprise and (ii) are not subject to the empire building interests of management.
(d) Dividends and profit distributions become tax deductable like interest payments. This substantially reduces the incentive for enterprises to borrow excessively that can send them bankrupt and/or create asset bubbles to create a systematic threat to the financial system as is currently evident.

**Q1.2** Both dynamic properties rights and a neutral enterprise tax system as described above would promote greater economic growth because:

(a) Dynamic property rights (i) reduce the export of surplus profits and windfall gains to foreign interests; (ii) reduce the dead weight cost of government transfers through taxes and welfare; (iii) would create an incentive for corporations to distribute all their profits and rely on growth from competitive dividend re-investments to improve the efficiency of resource by removing management conflicts to "empire build".

(b) A neutral enterprise tax system increase growth through increased efficiency in allocating finance between alternatives and the re-investment of their profits.

**Q5.1** In considering "the future of Australia's retirement income system" the objective is that all Australian should obtain the option to obtain a living income without work or welfare. This would allow policies of full employment to be replaced with a policy of fulfilment in employment or leisure as proposed in Chapter 2 of my book *Democratising the Wealth of Nations*. The introduction of dynamic property rights provides a mechanism to introduce universal property ownership to provide a dividend for all citizens and a way to introduce "Social Capitalism", described in the last Chapter in my book.

**Q6.1** The tax system can be structured to attract investment on a basis that investors are not overpaid with surplus and windfall profits by introducing tax incentives for the adoption of dynamic property rights so foreign ownership is transferred to Australian citizens after the investor's time horizon. Refer to the answers to Q1.1 and Q1.2 with their references. Besides increasing Australian ownership and limiting the ability of investors getting overpaid an ownership reversion tax trade-off would contribute directly to augment pension income

**Q6.3** The tax system can improve resource allocation as explained in answers to Q1.1 and Q1.2 with their references

**Q6.4** The principal goals that "should inform the taxation on capital gains" is that it is much more efficient and equitable to transfer capital gains through dynamic property rights as described in my book referred in Q1.1 to democratise the wealth of nations. Wealth is distributed in the private sector without the need for public sector transfers.

**Q6.5** A neutral tax system is proposed in the answer to Q1.1.

**Q6.6** When small business in Australia suffer a loss they should obtain the facility of obtaining a tax refund up to the value of the taxes paid during the previous three years as was available in the US. In this way they can obtain working capital when it is most needed and there is an incentive for small business to pay tax if they know they can claim it back when it is most needed.

**Q9.2** Reform of the revenues available to local, state and national government should be modelled on the upward flowing cascade revenue system found throughout the world over past millenniums. All land in local government precincts should be mutually owned by resident voters with private ownership of all improvements except dwelling becoming owned by the land bank as they are written off for tax purposes. Rent/rates from all improvements and those fully depreciated and so owned by the land bank would finance local government expenditures with a surplus to fund their State Government, who would then forward part of their surplus to the federal government who would in turn fund international obligations.

Community Land Banks (CLBs) are described in *Democratising the Wealth of Nations* referred to in Q1.1 and in my 2008 cited paper 'Limitations in orthodox economic analysis of urban realty'.

**Q10.1** In respect to housing the tax regime should be as described in the answer to Q9.2 with no taxes except rents and no assistance to make housing affordable. Land value represents around half the cost of a house and land values are created by public investment in services such as roads, transport, water, sewerage, schools, hospitals and private investment in amenities such as places of employment, amusement and recreation. Any assistance to make home ownership or renting more affordable will create private profits for other property owners/investors unless all land is mutualised as described in Q9.2. The regime described in Q9.2 allows all land in an urban local government precinct to become self-financing to eliminate the cost of land for pioneer home owners, investors in rental housing and all other investors. By eliminating the cost of land, half price housing can be provided without ANY government assistance. With dynamic property rights all tenants would automatically become home owners without any additional payments at the same rate investors owning their dwelling wrote of their investment for tax purposes. Only tenants and home owners would acquire shares in the mutually owned land bank. As the dwellings typically only occupy around 20% or urban cites, the pro-rate value of the shares each tenant and home owners obtain in the Land Bank would be five times as much as the land occupied. Everyone is better off including commercial investors who save the cost of buying land and whose profit is not reduced by dynamic property rights to democratise the wealth of cities.

**Q10.2** The role of the tax system in housing affordability is described in answers to Q9.2 and 10.1.

**Q10.3** To ensure the housing stock and residential land are used efficiently, the tax regime should provide incentives to facilitate the formation of mutually owned CLBs as described in answers to Q9.2 and 10.1

**Q14.2** "The most appropriate method of charging for Australia's non-renewable resources" is not a resource rent tax but to apply dynamic property rights as explained in the answer to Q1.1 so investors do not get overpaid. Refer to my article: 'Resource Tax Alternative', *Economic Papers*, The Economic Society of Australia, 1:2, pp. 85–8, September, 1982.

**Q14.2** "The role of the tax system in ensuring that renewable resources are used both sustainable and efficiently is provide the incentive for dynamic property rights (explained in response to Q1.1) to be introduced so as to transfer ownership of the resources to employees and other Australian citizens who do not discount future cash-flows (refer to response to Q1.1). When individuals do not discount the value of future cash they can take a long term view on sustaining their personal income. To achieve this objective it is important that the employees who can determine the rate and efficiency of extracting non-renewable resources become significant owners *and controllers* of the activity.

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# A NEUTRAL ENTERPRISE TAX SYSTEM

*by*

***Shann Turnbull***

The 1975 Taxation Review Committee (Asprey) identified the need for tax reform in Australia, especially in regards to the taxation of company profits. Unfortunately, however, the options and analysis of the Committee was limited in scope. A neutral tax system for enterprise was not considered. A neutral tax system is one which treats the various legal structures of enterprises in the same way.

The tax treatment for co-operatives is the same but differs from that for companies. Corporate profits are taxed twice but this need not be so for co-operatives and trusts. The tax system is neutral both for co-operatives and trusts, financed by debt or equity. On the other hand the tax system heavily favours debt rather than equity with companies.

To ameliorate the problem of double taxation of corporate earnings the Asprey Committee recommended an imputation or credit system so that the individual is given credit for some or all of the tax already paid by the company on his dividends. This system is not neutral in regard to the legal structure of the enterprise. Nor is it neutral in regard to debt and equity sources of finance. If the imputation system is only partially applied then a division 7 tax problem would still remain. This problem becomes irrelevant to the neutral tax system which is applied to co-operatives and trust.

The neutral tax system does not discriminate between private and public companies.

In a neutral tax system the enterprise obtains a deduction to the extent it distributes its earnings. All enterprise tax can be avoided by paying out all earnings. Any need for more equity to finance growth is met by shareholders re-investing their dividends or through attracting new equity investors. The dividend payments could be expected to be considerably greater. This would increase the attractiveness of equity investment and the practicality of raising money through new share issues rather than by increasing liabilities. No significant change in dividend policy would be expected from the imputation system.

*JASSA/1979, No. 2 (June)*

A comparison between the present 'separate', and proposed 'imputation' and 'neutral' systems of enterprise taxation are presented in the table below for the Australian economy 1978/79. This table has been based on the figures used in the submission* to the Prime Minister of June 1978 made by the Australian Associated Stock Exchanges.

The submission identified four main criticisms of the present 'separate' tax system of corporate profits. These were:

1. It discourages the payment of dividends.
2. It encourages companies to finance expansion from retained earnings.
3. It encourages companies to borrow rather than raise new equity capital, even if they are relatively highly geared.
4. It tends to divert personal savings, especially the savings of those on low incomes, away from equity investment and towards fixed income or property investment.

Compared with the neutral system, the imputation system is not likely to make any significant corrections to the first three problems. It could ameliorate the fourth problem as it would make the after tax income yield on corporate equities relatively more attractive then debt investments, unit trusts, and co-operatives. But it would do this more for the high rather than the low income earners.

The neutral tax system, in comparison, would create a strong pressure for correcting all four problems. In addition, it has the very important advantages not present in the imputation system of being neutral in regard to debt and equity financing and the legal form of the enterprise.

Because the impact of the neutral system can be expected to be much greater it would make a far greater beneficial impact on the securities industry and the economy. It would lead to a boom in new issues, rights

(*) Published in JASSA, the Journal of the Securities Institute of Australia, March 1979 No. 1 p9.

trading, underwriting, and professional portfolio management. For the economy it would accelerate structural change with corporate re-investment decisions becoming subject to testing and acceptance in the stock market through the placement of new issues. The stock market would become really effective in performing the vital economic role of resource allocation.

Competition for new funds through new issues in the market place would produce a number of very valuable side effects. It should greatly improve the quantity and quality of corporate information as businesses compete for investor confidence for their survival and growth. Audit committees and other arrangements to improve self-regulation and investor confidence would develop as a result of market pressures.

Another advantage of the neutral tax system in comparison with the separate system is that it should provide more cash in the hands of shareholders. Lines 14 and 15 show this occurs when the dividend payout ratio increases to 75% which should be expected.

The neutral tax system would be one integral step towards a much more basic and profound reform in creating a cashflow tax system. This would remove the ambiguities between realised capital and trading profits and the problems of 26AAA and 26(a) of the Tax Act. These were also discussed in the Stock Exchange submission.

A cashflow tax system would be created from a neutral system by making all business cash expenditures, including those of a capital nature, a tax deduction. In this system there would be no tax deductions for depreciation and investment allowances but there would be a greater benefit of having all equity investment as a deduction. The deductions would operate on a similar basis to those that were available in some companies under section 77D of the Tax Act.

**ASSUMPTIONS** – (Made in Stock Exchange submission)

Line 1:— Pre-tax company income (before stock valuation adjustment), which was $7,718 million in 1976-77, will increase by 8 per cent in 1977-78 and by 15 per cent in 1978-79.

Line 4:— Company tax rates and allowances will remain unchanged. In 1977-78 the nominal tax rate of 46 per cent is likely to result in an effective rate of about 40 per cent after allowances for stock valuation adjustment and investment allowances. In 1978-79 we assume an effective tax rate of 42 per cent because of diminished investment allowances and a smaller stock valuation adjustment with lower inflation.

Line 8:— Dividend payments to individuals have risen from $624 million in 1973-74 to an estimated $680 million in 1976-77. Because of lower dividend payouts, and increasing ownership of shares by other than individual Australians (local and overseas financial institutions and companies) dividend payments to individuals have nevertheless fallen, as a percentage of company net income, from 21 per cent in 1973-74 to 17 per cent in 1975-76 and 15 per cent in 1976-77. We assume that introduction of imputation will, in the first year, stabilise the percentage payout to individuals at 15 per cent of company net income.*

Additional Note (Not included in Stock Exchange submission)

Line 16:— The individual tax rate is 47½% and a withholding tax at this level is collected with the neutral system by all companies on all dividends paid to all shareholders whatever their status. This provides a basis for tax credits as may be appropriate.

*Implicit in the figures is the fact that 30% of corporate dividends are received by individuals and 70% by other entities.

## COMPARISON OF ENTERPRISE TAX SYSTEMS AUSTRALIA 1978-1979

| | TAX SYSTEM | *SEPA-RATE | *IMPUTA-TION | NEUTRAL | | |
|---|---|---|---|---|---|---|
| | PROFIT PAID OUT AS DIVIDEND | 50% | 50% | 50% | 75% | 100% |
| LINE No. | | $M | $M | $M | $M | $M |
| 1 | Est. company income before tax | 9586 | 9586 | 9586 | 9586 | 9586 |
| 2 | Deduction for dividend paid | Nil | Nil | 2780 | 4170 | 9586 |
| 3 | Taxable Income | 9586 | 9586 | 6806 | 5416 | Nil |
| 4 | Company tax (42% of line 3) | 4026 | 4026 | 2859 | 2275 | Nil |
| 5 | Profit after tax | 5560 | 5560 | 3947 | 3141 | Nil |
| 6 | Total dividends paid | 2780 | 2780 | 2780 | 4170 | 9586 |
| 7 | Profits retained | 2780 | 2780 | 1167 | 3141 | Nil |
| 8 | Dividends paid to individuals (15% of 6) | 834 | 834 | 834 | 1251 | 876 |
| 9 | Individual tax payable on dividends at 47½% | — | 396 | — | — | — |
| 10 | Imputed dividends of individuals (8 + 9) | — | 1220 | — | — | — |
| 11 | Individual tax (47½% of 10) | 396 | 580 | 396 | 594 | 1366 |
| 12 | Imputed tax credit 9 | — | 396 | — | — | — |
| 13 | Net individual tax (10-11) | — | 184 | — | — | — |
| 14 | Cash to individual shareholders (8-13) | 396 | 650 | 438 | 657 | 1510 |
| 15 | Cash to corporate shareholders (6-8) | 1946 | 1946 | 1946 | 2919 | 6710 |
| 16 | Withholding tax on dividends (47½% of 15) | NA | NA | 924 | 1387 | 3187 |
| 17 | Total tax on company income (4+11+16) | 4422 | 4210 | 4179 | 4255 | 4553 |
| 18 | Cost to revenue | — | 212 | 243 | 167 | (131) |
| 19 | Total tax % pre-tax company income | 46 | 44 | 44 | 44 | 47 |

* Source: Australian Stock Exchange's submission to the Prime Minister of June 1978.