Submission to the Henry Tax review

Relentlessly printing and spending money may, with time, realign the self-interest of financial intermediaries with the social objective of lubricating our economic system. But by then we will be dancing with other demons: accelerating inflation and ballooning deficits. We must, therefore, attack financial instability at source by increasing the incentive to save and securing the channels by which savings are transformed into capital.

Currently, the Reserve Bank of Australia influences interest rates and thus the economy by buying and selling financial instruments. The RBA could also create and sell new savings-into-capital instruments to initiate an investment-led recovery.

A pre-tax savings vehicle could add to our capital stock on a dollar-for-dollar basis. These pre-tax dollars could be deposited with the RBA both through the pay-as-you-go (PAYG) tax payment system and through supplementary contributions. They should be inflation-protected and accessible to the saver at any time as income (minus provisional tax, which could be a declining function of the length of the deposit, tailing off to zero at, say, age 65).

If the average contributor saved 20 cents of income tax on every dollar deposited with the RBA, and the total tax cost was $42 billion (the size of the current fiscal stimulus package) this would produce a capital fund of $210 billion (a five-fold bang per buck): a pre-tax savings rate of about 20 per cent of national income. Some tax revenue used for superannuation concessions ($24.95 billion in 2009-10) could also be used to stimulate pre-tax savings-into-capital (as an alternative to the purchase of second hand shares etc by superannuation funds).

The RBA should then auction these pre-tax funds directly to financial intermediaries on a contractual basis (every dollar borrowed must either be spent on the nominated investment project, or returned). It would also be possible for the RBA or parliament to specify which broad investment category (business, residential etc) the funds should be allocated to.

The spread between the cost of these funds (the inflation rate) and the return (the interest rate charged) would generate a surplus which could either fund future investment projects or partly offset the initial tax cost of the savings vehicle.

When the current crisis ends and the negative financial sector externalities (spill over costs) imposed on us subsides, we can choose between two budget-balancing alternatives. First, we could pay for the pre-tax savings by increasing the tax on consumption (the goods and services tax). Alternatively, we could design an expenditure tax to replace (or supplement) all existing taxes (except “sin” taxes on tobacco, gambling, alcohol, petrol etc).

Under a consumed income system, PAYG provisional tax would continue to be levied, but tax returns would consist of two items (income and RBA deposits) with the difference between the two (expenditure) as the taxable residual. The tax rate should probably be progressive: spending, say, $20,000 per year would attract no tax, whilst spending above, say, $150,000 a year, would be taxed at the highest marginal rate.

In addition to replacing complexity with simplicity, such a system serves two masters: balancing the budget and increasing national savings (a consumed income tax should be revenue-neutral with respect to the taxes it replaces). The increase in national savings should increase capital per worker, boost productivity and wages, thus allowing both savings and consumption to rise (a virtuous rather than a vicious spiral).

The RBA would also acquire an addition policy lever. In any funding round, if the demand for these deposits outstripped the supply, and a further investment stimulus was deemed to be appropriate, other financial instruments (such as Treasury bonds) could be sold to finance the shortfall. Likewise, variations in marginal tax rates could increase the price of current relative to future consumption and thus provide an incentive to increase deposits. Alternatively, if no further stimulus was deemed appropriate, only those intermediaries offering to pay a higher interest rate would be funded (which should generate a larger surplus).

There are no perfect economic systems and our export income will continue to cycle up and down. We must also think carefully about the tax treatment offered to existing assets that are sold and deposited with the RBA (some liquidated asset are currently treated as concessionary taxable income, while others, such as bank deposits are not). But we can definitely supplement a crisis-inducing financial system with an uninterruptible flow between savings and capital. In the process, all “systemic” institutions (those whose failure would threaten the stability of our financial system) would be effectively relocated into the non-systemic category.

Ironically, under capitalism, labour has increasingly escaped exploitation (slavery, child labour, unsafe working conditions etc), but capital and credit can still be crunched by intermediaries. Increased regulation will change the products but not the incentives of the regulation-avoidance industry; and no doubt, post-tax dollars will continue to feed that sector. But our economic system would be more stable if we can design vehicles that directly channel savings into socially productive capital and thus bypass the tangled intermediation web.

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