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Chairman, Senate Economics Reference Committee

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Deputy Chairman, Senate Economics Reference Committee

Senate Standing Committees on Economics
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Dear Senators

I have pleasure in making the following submission as to your inquiry into Australia's taxation system. I note that the Australian taxpayer contributed to my Harkness Fellowship at Harvard University where I did my PhD in the history of the theory of taxation. I have always felt that they deserve a dividend on their investment and have been sorry that I was unable to do that much for them as a Commonwealth public servant.

Tax theory and tax policy is basically simple. It was worked out over 250 years ago by the French Physiocrats with whom Adam Smith basically agreed.

Concisely put, all national income is the product of land, labour and capital (that is, physical capital not some amorphous valuation of anything). Those three factors of production share that income between them as the rent of land, the wages of labour and the return on the stock of physical capital.

There are thus three things you can tax â€“ land, labour and capital. Only one of these cannot run away, emigrate, stop breeding, slack off, demand higher wages, be hidden or rust out. As the Americans say, go figure.

This was better understood in Australia around 1900 when the Carruthers Liberal Government in New South Wales and the Fisher Federal Labour government both moved to rate and tax land values. You might find Sir Joseph Carruthersâ€™ memoirs of interest in that regard as the move to rate or tax land was bipartisan, as reflected in Sir John Quickâ€™s observations in his *History of Land Tenure in the Colony of Victoria.*

Turning to the particular issues raised in the terms of reference, I make the following brief comments.

(a) the social and economic impact of taxing people who earn less than the cost of living;

> Adam Smith was clear and unequivocal on this. The wages of common labour should never be taxed, whether directly or indirectly by excises, GST or VAT. Pitt the Younger understood this when in 1799 in the first income tax he said that a

generous allowance should be made to exempt those who are raising the Kingâ€™s future subjects. By contrast, the Treasury has succeeded in taxing Australian families down to a birth rate of 1.6 children, well below replacement rate, and Australia is accordingly seeing demographic and fiscal implosion propped up by immigration, as in the late Roman Empire.

(b) assumptions used by Treasury in modelling income tax cuts;

Given that income tax cuts are across the board, across all classes of income, Treasury modelling can never properly capture productivity effects. A tax cut for labour or capital investment will produce more output but a tax cut for land income cannot produce more land.

(c) the tax arbitrage between onshore and offshore profits that encourage domestic profits to be transferred offshore rather than retained in Australia;

There are many countries with lower company tax rates than Australia's. Money flows downhill like water and income will always flow to the lowest tax jurisdiction possible. There is nothing surprising or evil in that. In particular, the low withholding tax rates on interest and royalty payments facilitate international tax planning by Australian and multinational groups. As regards royalties, which are very important for the pharmaceutical and IT industries in particular, if you wanted to seriously collect some money from multinational groups, you might consider imposing a 5% annual charge on the self-declared value of royalty and copyright protection in Australia with forfeiture of intellectual property to the Crown if not paid. That would not breach the World Trade Organisation treaties and would be a better way of collecting revenue from companies like Pfizer and Microsoft which have done rather well out of this economy.

(d) the tax arbitrage between onshore and offshore profits that puts companies domiciled in Australia at a competitive disadvantage to companies domiciled offshore;

Obviously a company such as HSBC which re-domiciled to Bermuda from Hong Kong has an advantage over Australian banks.

(e) the abolition of numerous tax loopholes that favour special interest groups, in particular foreign interests;

As noted above, you cannot really tax capital profits which are mobile. As Adam Smith observed, the merchant is a citizen of the world and will move his capital elsewhere. However, even the most footloose industry has to have a land-base somewhere (e.g. data centres) and you can collect a revenue from them by charging land values across the board. If people can earn super normal profits in Australia that fact will be reflected in competition for land to operate here and be reflected in higher land values whether of that company or of its Australian customers.

(f) the actual net company tax rate after franking credits have been refunded;

The net company tax rate on distributed profits is zero and is meant to be zero. The whole point of company tax imputation is to treat the company as a withholding agent for the ultimate taxpayer being the shareholder. This puts companies in a similar position to the taxation of partnerships and trusts where income is taxed once and once only in the hands of the ultimate recipient. In fact, the perfect tax treatment is partnership treatment where losses are also distributed to partners, which is not possible for trusts and companies.

(g) the cost of recycling franking credits to and from Canberra;

One expects the cost is no different to the business of crediting PAYG withholding amounts from employee wages against their income tax declarations

(h) whether capital gains tax concessions for passive investment cause a misallocation of capital into the non-productive economy which has to be offset by higher taxes on active income which drives down productivity and the velocity of money; and

Capital gains taxes are stupid taxes because they are transaction taxes, not holding charges. Capital gains tax is simply a variable stamp duty as far as land is concerned and one which is calibrated by reference to the purchase price. It has a serious â€œlock inâ€ effect which impedes the productive reallocation of land to its highest and best use and which rewards squatting. At the end of the day, all capital gains accrue in the value of debt or share assets or land or buildings or plant or equipment. But debt assets do not increase in real value and therefore have no ultimate capital gains. Buildings, plant and equipment depreciate in real terms. Goodwill of businesses which is reflected in share values is only the present value of a taxable future income stream and therefore taxing goodwill represents double taxation. The only real naturally appreciating asset is land and a uniform land value charge captures gains as they accrue on a regular basis without any distortion in favour of never selling.

(i) related matters.

Having been the subject of what Adam Smith's describes as a â€œvexatious inquisition by a naturally insolent race of menâ€, namely the boys and girls in the Australian Taxation Office, may I suggest that you ask the Commissioner of Taxation get his staff to study the history of English law and of taxation in its constitutional setting, in particular. One of my distant relatives was an Attorney-General to James II who lost his crown because a disagreement with his Parliament on the subject. From my experience I can only say that some of the Commissioner's servants seem to think they are running some sort of Asiatic despotism and have no concept whatsoever of the liberties of the subject or the fact that taxation is a gift to the Crown given by our collective consent as manifested by an Act of Parliament and is not meant to be some sort of ATO intimidation or extortion racket based on suspicion or guilt by association.

Yours faithfully

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