Public Revenue Without Taxation

A submission to the Treasury review on
"Australia's Future Tax System"

by
Gavin R. Putland
(Director, Land Values Research Group *)

October 17, 2008

Introduction and Summary

The macro-economic advantage of self-funded retirement is that retirees are not dependent on taxation, which distorts price signals and consequently diminishes economic activity, but merely become the recipients of naturally existing prices. That raises the question: **If retirees can live on income from assets instead of burdening the taxpayer, why shouldn't governments do the same?**

One might claim that governments would first need to finance the acquisition of the necessary assets while continuing to meet recurrent expenditure. If that claim were true, it would not be a respectable excuse, because recent Australian governments have happily required working generations to save for their own retirements through compulsory superannuation while continuing to pay taxes for the pensions of earlier generations; the cost of those superannuation contributions, although nominally borne by employers, is shifted onto working families through higher prices of goods and services or lower wages.

But the claim *isn't* true. An asset portfolio yielding just enough income to replace the taxes imposed by any particular government will have the same market value that the power to impose or avoid those taxes would have, if that power were a tradeable asset. Therefore the government in question should be able to acquire the necessary assets (or shares thereof) in return for tax exemptions.

Moreover, the acquisition would *not* need to be compulsory. As the asset "sellers" would avoid not only the actual taxes, but also the associated compliance costs and **deadweight costs** (lost opportunities because of otherwise viable activities rendered unviable by taxation), tax exemptions would fairly exchange for *more* than enough assets to replace the lost revenue. The saving in deadweight costs would be a net benefit that could be shared between the government and each taxpayer, making the exchange mutually beneficial. And mutually beneficial exchanges do not need to be forced; they will entered into *voluntarily* if the law merely *permits* them.

For political purposes, **the best tax reform is an *optional* reform: if you don't like the new system, you don't have to vote against it, because if it goes ahead you won't have to be part of it.** Any opponents of an optional reform must explain why they want to *impose* the status quo and *deprive the people of choice*.

Asset owners who surrender negotiated shares of their assets to the government would pay rent on the government's stake, in lieu of taxes. Taxpayers who do not own suitable assets (hereinafter described as **assessable assets**) will at least hold tenancies, of which they could surrender negotiated shares to the government in return for tax exemptions. A tenant choosing this option would pay

out the government for its share of the tenancy, in lieu of taxes. Together, shared equity and shared tenancy would enable *all* taxpayers to opt out of the tax system.

There are ample precedents for *voluntary* tax reform. In past centuries, the UK Parliament passed numerous Land Tax Redemption Acts whereby the tax on a property could be permanently removed by paying so many years' tax in one instalment. The exercise of this option amounted to paying an extra tax in order to buy out the Crown's residual interest in the land. A modern taxpayer, in view of the far greater complexity of the tax system, might well prefer the reverse arrangement: surrendering an interest in the land in return for tax exemptions. The ancient racket known as **tax farming**, whereby a private entity acquired the right to tax in return for sharing the proceeds with the government, has its modern equivalent in the privatization of public utilities, for which the user charges are subsequently set far in excess of marginal costs. Such arrangements were and are voluntary—for the tax farmers. Would that the rest of the citizenry had the same choice.

Accordingly we submit that in every tax jurisdiction, it should be lawful for the Executive Branch to enter into a contract with any entity, whereby the entity shall no longer pay taxes to the Executive Branch provided that the entity grants to the Executive Branch

> (a) a negotiated percentage of the equity in each assessable asset that the entity owns, plus
>
> (b) a negotiated percentage of the tenancy in each assessable asset that the entity occupies or uses, plus
>
> (c) a standard percentage of the equity in each assessable asset that the entity subsequently acquires, plus
>
> (d) a standard percentage of the tenancy in each assessable asset of which the entity subsequently becomes the occupant or user,

and provided that if the entity sells an assessable asset, the equity held by the Executive Branch in that asset shall thereafter be the standard equity percentage referred to in clause (c).

In the case of owner-occupation, ownership and tenancy must be treated separately because they may subsequently be, and may previously have been, held by separate entities.

In a jurisdiction responsible for a welfare system, the enabling legislation could stipulate that natural persons accepting shared equity/tenancy contracts would simultaneously enter a new welfare system free of distorting means-tests and eligibility tests. The negotiated percentages and standard percentages would then need to be higher; but these are non-distorting.

To ensure the adequacy and stability of the revenue base, the category of "**assessable**" assets must include all types of assets that taxpayers cannot create or eliminate or move out of the jurisdiction. To avoid discouraging taxpayers from joining the new system, the category must not include any assets that are outside the jurisdiction. The most obvious example of an assessable assets is a **site**—that is, a piece of ground or airspace, including any attached building rights or other rights, but *excluding* any actual buildings or other works. Reasons, other examples, other implementation details, and "template" legislative code are given in the following text.

Contents

The unstable and perishable nature of stock and credit . . . render them unfit to be trusted to as the principal funds of that sure, steady, and permanent revenue which can alone give security and dignity to government. The government of no great nation that was advanced beyond the shepherd state seems ever to have derived the greater part of its public revenue from such sources.

Land is a fund of a more stable and permanent nature; and the rent of public lands, accordingly, has been the principal source of the public revenue of many a great nation that was much advanced beyond the shepherd state. From the produce or rent of the public lands, the ancient republics of Greece and Italy derived, for a long time, the greater part of that revenue which defrayed the necessary expenses of the commonwealth. The rent of the crown lands constituted for a long time the greater part of the revenue of the ancient sovereigns of Europe.

— Adam Smith, *The Wealth of Nations*, Bk. V, Ch. II, Pt. 1.

In China, the principal revenue of the sovereign consists in a tenth part of the produce of all lands of the empire. This tenth part, however, is estimated so very moderately that, in many provinces, it is said not to exceed a thirtieth part of the ordinary produce. The land-tax or land-rent which used to be paid to the Mahometan government of Bengal, before that country fell into the hands of the English East India Company, is said to have amounted to about a fifth part of the produce. The land-tax of ancient Egypt is said likewise to have amounted to a fifth part.

In Asia, this sort of land-tax is said to interest the sovereign in the improvement and cultivation of land. The sovereigns of China, those of Bengal while under the Mahometan government, and those of ancient Egypt, are said accordingly to have been extremely attentive to the making and maintaining of good roads and navigable canals, in order to increase, as much as possible, both the quantity and value of every part of the produce of the land, by procuring to every part of it the most extensive market which their own dominions could afford.

— Adam Smith, *The Wealth of Nations*, Bk. V, Ch. II, Pt. 2, Art. I.

1 Rent in lieu of tax

The legislative embodiment of a **voluntary shared-equity/shared-tenancy system** in any municipality, state, or country would be unusually simple. The essence of it would be contained in a single paragraph to the following effect:

> ***(1)*** *Notwithstanding any other law made by this legislature with respect to taxation, it shall be lawful for the Executive Branch to enter into a contract with any entity, whereby the entity shall no longer pay taxes to the Executive Branch provided that the entity grants to the Executive Branch*
>
> > ***(a)*** *a negotiated percentage of the equity in each assessable asset that the entity owns, plus*
> >
> > ***(b)*** *a negotiated percentage of the tenancy in each assessable asset that the entity occupies or uses, plus*
> >
> > ***(c)*** *a standard percentage (hereinafter called the* ***standard equity percentage****) of the equity in each assessable asset that the entity subsequently acquires, plus*
> >
> > ***(d)*** *a standard percentage (hereinafter called the* ***standard tenancy percentage****) of the tenancy in each assessable asset of which the entity subsequently becomes the occupant or user,*
>
> *and provided that if the entity sells an assessable asset, the equity held by the Executive Branch in that asset shall thereafter be the standard equity percentage.*

Obviously it is intended that the Executive Branch will receive rent for its equity fractions (like a co-landlord) and for its tenancy fractions (by way of compensation for not exercising the rights of a co-tenant), and that the rent will replace the forgone taxes. But one clarification is required:

> ***(2)*** *For the purposes of paragraph (1), ownership and tenancy of an assessable asset shall be treated separately, even if the same entity is or becomes both the owner and the tenant, and even if it is not customary for occupation or use of that type of asset to be separated from ownership.*

Will the strict separation of ownership and tenancy lead to double counting of asset values? Yes, but that is inconsequential because the aim is not to conduct a census of asset values as such, but rather to negotiate the replacement of the revenue from existing taxes, some of which are paid by asset owners *as owners*, and some of which are not. Roughly speaking, double counting of asset values means halving of negotiated percentages.

2 Protecting the revenue

An entity under a shared-equity contract can avoid the rent on an assessable asset by selling that asset and buying another outside the jurisdiction. If the asset is sold to an entity still inside the tax system, the Executive Branch must retain its equity in the asset, lest there be a loss of revenue; such a loss would be the more likely because buyers who *voluntarily* stay inside the tax system must have their reasons. In order to preserve the privacy of the sellers' tax history, and in order to prevent different negotiated equity percentages from turning into long-term anomalies, paragraph (1) provides that the negotiated percentage reverts to a standard percentage after the sale. Of course this provision would

affect the sale price; but it would not cause any injustice, because it would be taken into account by the prospective seller when negotiating the terms of exit from the tax system.

There is no corresponding provision concerning transfer of a *tenancy*, because that would empower a tenant to impose conditions on future tenancies. While a tenant under a contract could avoid public rent by abandoning a tenancy inside the jurisdiction in favour of one outside, this does not require any corrective action, because it is not peculiar to shared-tenancy schemes; under *any* system of taxation, it is quite normal for emigration to cause a loss of revenue.

Paradoxically, however, the strongest safeguard against net loss of public revenue through tax/rent exchanges is the mere fact that such exchanges would be *voluntary*. As the Executive Branch would not be obliged to contract with any particular taxpayer, it would not need to accept any arrangement involving a risk of lost revenue.

For this reason, the enabling legislation need not foresee every issue that might arise; any questions left open by the legislation could be resolved in the contracts. Because the benefits of experience gained from early contracts would appear in later contracts far sooner than they could appear in any legislative amendments, the enabling legislation need not include elaborate "anti-avoidance" measures of the sort commonly found in tax laws; if the Executive Branch smells a rat, it simply won't accept the deal. So the "anti-avoidance" provisions of the legislation (apart from definitions, which are considered below) would be limited to a brief, broad statement such as the following:

> ***(3)*** *In assessing any proposed contract under paragraph (1), the Executive Branch shall give paramount consideration to the protection of public revenue, net of expenses incurred in the collection thereof. In particular, the Executive Branch may:*
>
> > ***(a)*** *require that the entity dispose of or fully utilize certain assets before the contract takes effect;*
> >
> > ***(b)*** *require that specified related entities be included in the contract or conclude separate contracts;*
> >
> > ***(c)*** *stipulate that an entity under a contract shall not receive non-market income from other entities.*
>
> *But while any such contract remains in force, the entity shall have the controlling interest in each affected asset holding or tenancy, even if the entity's numerical share of the equity or tenancy is less than 50 percent.*

By judicious use of such terms and conditions, the Executive Branch could prevent a taxpayer from (i) avoiding transfer taxes on imminent sales of assets, (ii) hoarding assets, failing to generate taxable income from them, using the low tax-to-assets ratio to negotiate low public equity fractions on exit from the system, and eventually selling the assets tax-free, or (iii) remaining in the tax system while transferring taxable income to a related entity that has opted out on favourable terms. For added security, clause (a) refers to "assets", not "assessable assets". But the "controlling interest" ensures that when the bargain is eventually struck, the former taxpayer's freedom is not compromised.

3 Definitions and explanatory notes

3.1 What is an "entity"?

Within the relevant tax jurisdiction:

> ***(4)*** *In this Act, an* ***entity*** *is an actual or potential payer of taxes to the Executive Branch.*

Note that according to this definition, an "entity" need not be domiciled within the jurisdiction. For example, under present laws a U.S. company operating in Australia would pay (among many other things) local rates to each municipality in which it owns real estate, payroll tax to each Australian State or Territory in which it employs people, and GST to the Federal government. The respective "relevant tax jurisdictions" are the municipality, the State or Territory, and the nation-state.

The word "potential" allows new entities (e.g. new firms) and other entities about to become taxpayers (e.g. young people entering the workforce) to opt out of the tax system even before they become liable to pay.

3.2 What are "taxes"?

For present purposes, **taxes** include all payments to the Executive Branch except fines, proceeds of sales of goods and assets, and *per-unit* user charges. The usual distinction between taxes and charges, namely that charges are requited while taxes are not, is followed. For example, mining and logging royalties, whether "specific" (apportioned to quantity) or *ad valorem* (apportioned to value), are per-unit user charges (being payments for depletion of resources owned by the people); but annual "fees" for mining and logging licenses are taxes (being far in excess of the government's associated costs). Road/bridge tolls and public transport fares are per-unit user charges; but annual "fees" for vehicle registrations and drivers' licenses are taxes (because, while the *initial* registration or license grant involves some work for the government, this is not repeated every time the registration or license is renewed). Sewage discharge tariffs and water/gas/electricity consumption tariffs are per-unit user charges. But *annual* fees for "connection" to such services, if payable to a government, are taxes (because any expense incurred by the provider of the "connection" is one-off, not annual). A parking fee levied on a motorist for parking on a public street for a limited time is a per-unit user charge; but a parking-space levy paid by a private property owner who provides parking on his/her own property is a tax. These examples have been chosen because they are on the borderline; most cases are more obvious. The prevalence of official euphemism is also helpful: if it's officially called a tax, it's probably a tax.

While the exclusion of per-unit user charges is conceptually simple enough, perhaps the safest way to define "taxes" in the enabling legislation is to list them by name:

> ***(5)*** *In this Act,* ***taxes*** *include:*
>
> > ***(a)*** . . .

The laws imposing the taxes could also be cited, if needed for clarity. That would take care of *current* taxes. To allay any fear that the contracts will be undermined by *new* taxes, the list would probably need to end with a catch-all item like:

> ***(..)*** *other sources of public revenue subsequently enacted by this legislature (excluding fines, proceeds of sales of goods and assets, and per-unit charges on users of services).*

3.3 Why retain per-unit user charges?

Service charges can be defended as a means of rationing the use of services. Economic theory tells us that the use of a service will be socially optimal if it is priced at the **marginal cost**, i.e. the cost of providing the *next unit* of service—not to be confused with the **fixed** cost, which is incurred regardless of utilization, or the **average** cost, which is the total cost (including the fixed cost) divided by the number of units provided. In many cases, including public transport, a reasonable approximation to marginal-cost pricing is to charge a nominal amount during times of peak demand, with no charge at off-peak times.

It so happens that some user charges are substantially *above* marginal cost. For example, public transport fares are often inflated in an attempt to recover not only marginal costs but also fixed costs (including capital costs) through fares. The attempt is futile because high fares mean low patronage. This in turn creates a perception that public transport is unviable, causing under-provision of services (hence the peak-hour congestion that makes patronage look better than it is).

The most efficient way to meet the fixed costs of public infrastructure, including public transport and connection to reticulated services (electricity, gas, water, sewerage, drainage), is to recycle part of the **uplift in land values** caused by the provision of infrastructure. Under a shared equity/tenancy arrangement, such recycling occurs automatically because the government, which has the authority to provide at least some forms of infrastructure, has an interest in at least some of the land whose value is enhanced by the infrastructure. (This is another reason for classifying annual fees for "connection" to reticulated services as "taxes" to be eliminated under shared equity/tenancy contracts.) When fixed costs are covered by recycling uplifts in land values, user charges can be reduced to more efficient levels. For this reason it might be desirable to pass separate legislation whereby parties to shared equity/tenancy contracts receive discounts or partial exemptions from certain user charges. But because such charges serve a purpose other than raising revenue, they should not be entirely eliminated under the terms of shared equity/tenancy contracts.

3.4 Who is deemed to "pay" a tax?

The key words in paragraph (1) are "shall no longer pay taxes *to the Executive Branch*" (emphasis added). To the extent that a consumption tax is eventually paid by the consumer, it is paid either in the retail price or in a surcharge thereto. But the consumer pays the tax *to the retailer*, not to the Executive Branch. The party who pays the tax to the Executive Branch (i.e. who **remits** the tax) varies with the type of consumption tax. For a U.S.-style sales tax, it's the retailer. For the obsolete wholesale sales tax, it's the last seller before the retailer. For the ubiquitous VAT (known as the GST in New Zealand, Canada, Australia, and Singapore), it's everyone who adds value in the supply chain (and furthermore every remitter's calculation involves both sales and inputs, making VAT the preferred consumption tax among those whose aim is to maximize compliance costs in order to give big business an advantage over small business).

So why doesn't paragraph (1) say "remit" instead of "pay"? The reason relates to personal income tax (PIT). If a government that imposes PIT is to acquire enough shared equity or tenancy to replace PIT (or to pay for infrastructure through uplifts in land values), ordinary wage/salary earners must be persuaded to accept contracts, and must therefore get the benefit of avoiding PIT. But in most jurisdictions, PIT is initially remitted by the employ*er*, and the employ*ee* settles the account with the Executive Branch at the end of the year. To allow for this, the enabling legislation could say:

> ***(6)*** *For each type of tax, for the purposes of paragraph (1), the party deemed to* ***pay*** *the tax shall be the party responsible for the final settlement of the account with the Executive Branch.*

Or the parties that "pay" could simply be listed along with the taxes.

From paragraphs (5) and (6), taxpayers can work out what taxes they would avoid by accepting shared equity/tenancy contracts with a particular government. Of course if they pay taxes to more than one government, as they probably do, a contract with one government will eliminate only *some* of their taxes. But along with each tax it will also eliminate the associated **compliance cost**, which is the cost (in cash or kind) of calculating tax obligations and maintaining the necessary records, *and the associated* ***deadweight cost***, which is the value of opportunities lost because otherwise viable transactions or projects are rendered unviable by the tax and/or its compliance cost (although we

concede that the apportionment of costs between entities is more problematic for deadweight costs than for compliance costs).

3.5 What is an "assessable asset"?

For a *typical individual taxpayer*, the only assessable asset owned or rented will be the *site of one's residence*. For a *typical small enterprise*, the only assessable asset owned or rented will be the *site of one's business premises*. That answers the question for most taxpayers. The types of assessable assets involved in shared equity/tenancy contracts would be more numerous for taxpayers with more complicated affairs, but probably not as numerous as the taxes that they could subsequently forget about.

If every taxpayer in the jurisdiction accepts a shared equity/tenancy contract, the government will thereafter derive revenue only from its shared ownership and shared occupation/use of **assessable assets**. If those assets do not subsequently appreciate at least in proportion to the government's revenue requirements, then the government will have to choose between cutting services (politically difficult, if not unconscionable), breaching the contracts (politically suicidal, if not unconstitutional), and inflating user charges above marginal costs (economically inefficient). If only *some* taxpayers accept contracts, any shortfall in revenue from shared ownership and shared tenancy will impose an unfair burden on the remaining taxpayers, who, if they then opt out of the tax system by accepting contracts, will do so on less favourable terms than their predecessors. If such adverse outcomes are to be avoided, the assets classified as "assessable" must be such that they *appreciate in response to economic growth*.

That requirement is met by the following definition: **An "assessable" asset is one which is located within the jurisdiction and which private entities cannot replicate, eliminate, or move out of the jurisdiction**. If assets outside the jurisdiction were assessable, the revenue system would be extra-territorial, causing multiple taxation of the same assets, and requiring each former taxpayer to deal with too many jurisdictions and each jurisdiction to deal with too many assets. If "assessable" assets could be destroyed or otherwise eliminated, they might not appreciate *collectively*, and entities under contracts would be able to avoid public rent payments by destroying the assets (or failing to maintain or replace them). If "assessable" assets could be freely replicated, they would fail to appreciate *individually*, because any such appreciation would induce additional production, which in turn would devalue the existing stock. Worse, production by entities that are still in the tax system would devalue assets held by entities under contracts, causing a loss of public revenue. But if "assessable" assets *cannot* be freely replicated, the increase in effective demand for such assets (caused by economic growth) cannot induce an increase in supply, but is reflected in increasing rents and prices.

It is clear that under the above definition, assessable assets *exclude buildings, plant and equipment, and goods and chattels.*

The most obvious type of asset that private entities can neither replicate nor eliminate is *space*. For economic purposes, space is divided into *sites*—a **site** being a piece of ground or airspace, including any attached building rights or other rights, but (as we have just noted) *excluding* any actual buildings or other works. As sites are defined in terms of **location**, they cannot be taken out of the tax jurisdiction, which itself is defined as a range of locations. By conferring additional rights on the use of space, governments can add value to sites or effectively create sites (as when building-height limits are increased); but private entities cannot do these things. Growth of the local economy can also add value to sites; but a single private entity (unless it is freakishly large) cannot significantly drive that growth. Moreover, sites are especially suitable for shared equity/tenancy contracts because *every* entity must own or occupy a site. We may therefore consider sites as the archetypal, quintessential "assessable" assets, and all other assessable assets as **site-like**.

Licenses satisfy the definition of "assessable" provided that they are strictly **limited in supply**

and that their use is **confined to the jurisdiction**. From the viewpoint of applicants, if a license can be obtained by achieving a prescribed level of competence regardless of how many such licenses have been issued to other applicants, the license is effectively created by the *applicant* in reaching the prescribed level, and is therefore non-assessable. Drivers' licenses are of this nature. But if one wants to drive a car in Singapore, the car must have an attached "Certificate of Entitlement", and the supply of those certificates is limited by the government; such certificates are assessable. Also assessable are taxi licenses (also known as **taxi plates**) in any jurisdiction in which their number is artificially limited.

That the use of a license be "*confined to the jurisdiction*" is also critical. If a license were usable outside the jurisdiction, the privilege conferred by it would not be entirely located within the jurisdiction, or could be effectively taken out of the jurisdiction by emigration of the licensee. For example, if the number of taxi plates in a certain region is limited by the State, and if a municipality covers only part of that region, then the use of each plate is not confined to the municipality. So the plate would be assessable for the purpose of opting out of the State tax system, but not for the purpose of opting out of the municipal tax system. But licences limited in number and issued by a *municipality* would be assessable for both State and municipal purposes, because any use within the municipality is also within the State—just as a site located within the municipality is also located within the State and is therefore assessable for both State and municipal purposes.

Other licenses whose supply is often limited include **gambling licenses**, **water rights** (excluding volumetric charges), **fishing/logging/mining/drilling rights** (excluding per-unit royalties), **tradeable emission rights** (not per-unit pollution charges), **easements** and **rights of way**, **airport/seaport time slots**, and **electromagnetic spectrum assignments**.

The limits in question are not always imposed by governments. Only so much water flows through the rivers. There are only so many known mineral deposits, usable harbours, and suitable locations for airports. There are only so many sites over which easements or rights of way can be granted. When a government *does* impose a limit, it may do so out of necessity or perceived necessity. Only so much fishing or logging is sustainable. Only so much pollution is tolerable.

A **monopoly** is the extreme case of a limit on the number of licenses: just one license. Examples include **patents**, **registered designs**, **trademarks**, and **copyrights**—in short, **intellectual property** (**IP**). (Of course the owners of IP rights may grant non-exclusive "licenses" and permit replication of works under "license"; but the IP rights themselves are exclusive and non-replicable.)

Again, not all monopolies are created by governments. A networked service, for example, is by nature a monopoly—a **natural monopoly**—because any competitor wanting to sign up its first customer must either replicate the network or connect to the existing network. The former option is too expensive for one customer, and the latter involves *becoming* a customer of the incumbent network owner, who of course will not welcome competition. Even if the existing network was initially *created* by one private entity, it cannot realistically be *replicated* by another if the other is to be competitive. Furthermore, because such a network has a spatial dimension, its "creation" requires numerous other assessable assets, especially sites, easements, and rights of way.

So the enabling legislation would say something like:

> ***(7)*** *In this Act, an* ***assessable asset*** *is an asset which is inside [this jurisdiction] or under its authority, and which no entity can replicate, eliminate, or remove from [this jurisdiction].*
>
> ***(8)*** *At the time of commencement of this Act, for the purposes of paragraph (7), assessable assets shall include, without limitation: . . .*

Then would follow a list appropriate to the jurisdiction. The phrases "At the time of commencement. . . " and "without limitation" leave open the possibility that the list may grow in response to

technological or constitutional change. A late addition to the list would not cause any sudden change in rent payments, because under paragraph (1) no rent would be payable on a newly assessable asset until the next transfer of ownership or tenancy. Even the resale price of an asset would not be greatly affected by its reclassification as assessable, because the reclassification would be anticipated and "priced in" long before the implicit assessability became explicit.

3.6 What are the "standard" percentages?

First note that these percentages would not be prominent in the calculations of taxpayers opting out of the tax system, because the initial equity and tenancy percentages would be negotiable. The "standard" percentages would be relevant only to subsequent sales, acquisitions, and new tenancies.

But, in answer to the question, the enabling legislation would say something to the effect:

> ***(9)*** *The* ***standard equity percentage*** *shall be X percent, unless a lower percentage is fixed by regulation. The* ***standard tenancy percentage*** *shall be Y percent, unless a lower percentage is fixed by regulation. Any change in the regulation fixing the standard equity percentage or standard tenancy percentage shall be subject to disallowance by this legislature.*

In practice, the standard equity and tenancy percentages would be *initially* set at *X* percent and *Y* percent, but would tend to fall in the long term because the values of assessable assets would tend to grow faster than revenue requirements, and because politicians are under competitive pressure to minimize those requirements. Therefore the maxima *X* and *Y* would tend to become entrenched: in theory they could be increased simply by amending the legislation, but in practice it would take an extreme emergency to make any such increase politically acceptable.

Because the required standard percentages would decline in the long term, the maxima *X* and *Y* would be calculated to ensure adequacy of revenue in the short to medium term. Specifically, *X* would be the total tax currently paid to the Executive Branch by assessable-asset owners *as owners*, expressed as a percentage of the total rental value of the assets; and *Y* would be the total tax currently paid to the Executive Branch by assessable-asset tenants *as tenants*, expressed as a percentage of the total rental value of the tenanted assets. For an owner-occupant, the precise boundary between "as owners" and "as tenants" does not greatly matter, because the preservation of revenue depends on the *combination* of *X* and *Y*, not the precise division of revenue between the two. But by way of illustration, taxes paid by a property owner-occupant *as owner* include property taxes and (in some jurisdictions) income tax on imputed rent, while all taxes unrelated to ownership are paid *as tenant*; but all taxes paid by an absentee landlord in respect of a rental property are paid *as owner*. For the owner or tenant of more than one assessable asset, there is no need to apportion the tax liability between those assets in the calculation of *X* or *Y*.

N.B.: The calculation of *X* and *Y* would not need to be very precise by fiscal standards, because by the time enough assets had changed hands to make the standard percentages important influences on total revenue, the standard percentages would have dropped substantially below *X* and *Y*.

3.7 What is a "tenant"?

> ***(10)*** *For the purposes of this Act, a* ***tenant*** *of an assessable asset is an occupant or user of the asset, whether as principal lessee or as sub-lessee.*

If subtenancies were not included, individual taxpayers who cannot afford to be owners or principal tenants would be unable to opt out of the tax system.

3.8 Review

The outline of the enabling legislation (indented and italicized) is now complete in so far as it relates to tax reform. (Welfare reform is yet to be discussed.) The reader may compare its complexity with that of any existing piece of tax legislation, e.g. Australia's 5743-page *Income Tax Assessment Act*.

4 Positive effect on asset values

4.1 All taxes come from economic rent.

Because assessable assets cannot be produced by private agents, the returns on such assets, whether in the form of rent or capital gains, cannot serve as incentives to produce the assets; in other words, the returns are **economic rent**. Hence there is no loss of incentive if the returns are diminished by holding charges on the assets (e.g. shared-equity rents).

From the viewpoint of the taxpayer, the supply of assessable assets within the jurisdiction is *fixed*. For example, the overall supply of *land* in the jurisdiction is fixed, as is the supply of land legally usable for any particular purpose, or within acceptable distance of any particular services, infrastructure, or markets. Yet access to assessable assets is essential to life and livelihood. For an wage-earner *per se*, the one essential assessable asset is a residential site. For a retailer *per se*, it's a commercial site. For a taxi driver *per se*, it's a plate. But for every economic agent, securing access to some part of that limited pool of assessable assets is a prerequisite for economic participation. Therefore rents and prices of assessable assets are bid upward until they absorb the economy's capacity to pay.

This mechanism explains why growth in "real wages" has not solved the problem of housing affordability: whatever has been gained in the labour market and elsewhere has been competed away in rents and prices of residential sites. Such a conclusion should not be surprising; the persistence of a housing problem in the teeth of so many centuries of economic progress indicates that the primary cause is to be found in universal economic laws, not in any peculiarities of the present.

Because the economic rents of assessable assets absorb the capacity to pay, and because all taxes are deductions from that capacity, all taxes are ultimately borne by the owners of assessable assets as deductions from their economic rents. It follows that if all taxes were levied *directly* on assessable assets, the owners would be no worse off; that is, their after-tax economic rents would be undiminished. Hence, in a rational market, the transfer prices of the assets, i.e. the discounted present values of their anticipated after-tax economic rents, would also be undiminished. John Locke made essentially the same point more than 300 years ago:

> It is in vain, in a country whose great fund is land, to hope to lay the publick charge of the Government on anything else; there at last it will terminate. The merchant (do what you can) will not bear it, the labourer cannot, and therefore the landholder must: and whether he were best to do it by laying it directly where it will at last settle, or by letting it come to him by the sinking of his rents,... let him consider.[1]

Now one way of laying the public charge "directly where it will at last settle" is to keep a share of the value of the land and other assessable assets in public hands, and to charge rent for the public share.

4.2 All deadweight costs come from economic rent.

In fact the owners of assessable assets could better bear the public charge "by laying it directly where it will at last settle," because the margin by which taxes reduce the capacity to pay for such assets,

[1] *Some considerations of the consequences of the lowering of interest, and raising the value of money* (attached to a letter dated November 7, 1691).

and hence the values of the assets, includes not only the taxes themselves but also their deadweight costs: the asset owners are overcharged!

Unlike taxes, rent shares payable by owners and tenants would not deter any productive activities carried out in the course of ownership or tenancy, but rather would make such activities all the more necessary as means of paying the rent. Thus the negative effect of deadweight on asset values would be eliminated; the owners would no longer be overcharged.

In practice, in the negotiation of each shared equity/tenancy contract, the saving in deadweight costs plus compliance costs would be a net benefit to be divided between the taxpayer and the Executive Branch, making the contract mutually beneficial. For the purpose of computing the economy-wide effects of these savings, the per-contract savings in compliance costs are additive only in so far as they are incurred in *kind*, because a cost incurred in cash is a benefit to the payee; but the perceived savings in deadweight costs are *better* than additive, because individual traders suffer deadweight not only because of their own tax liabilities but also because of others' liabilities.

4.3 Value vs. affordability

If owners of assessable assets would be better off under shared-equity contracts than under taxation, does that mean everybody else would be worse off? No, because the owners' gain would be funded by overall economic growth, not by anyone else's loss. Furthermore, not all of the benefit of that growth would go to asset owners. The rent payable on the public share of an unused or underused assessable asset would induce the owner to cover the rent liability by attracting a tenant, or avoid the rent by selling the asset. Thus it would strengthen the bargaining positions of renters and prospective buyers, ensuring that they would share in the growth.

4.4 Promoting investment in infrastructure

So far, in explaining the advantages of shared equity/tenancy over taxation, we have considered only what happens when the revenue is collected—not what happens when it is spent. A core spending responsibility is infrastructure, including network infrastructure such as transport, waste disposal, water, sewerage, and drainage, and community infrastructure such a schools, libraries, and emergency services.

The benefit of an infrastructure project is measured by the total price that people are willing to pay for it. Part of that price is paid in user charges (fees, fares, tolls, volumetric tariffs, etc.) and the rest is paid in rents and prices of *locations* that benefit from the project—in other words, property values. And the locational component of the value of a property is the *site value*, not the values of any buildings, because the value of a building is limited by its depreciated replacement cost, whereas a site has a location, and therefore a locational value, even if no building yet occupies it. Therefore, if the benefit of an infrastructure project exceeds the cost, whatever part of the cost is not covered by user charges can be covered by taking back a sufficient fraction of the *uplift in site values*. One way to do this is to have a sufficient fraction of the site value in public ownership by means of a shared equity/tenancy scheme.

Conversely, if the government, through shared equity and shared tenancy, collects a fraction of the rental values of assessable assets, it has a fiscal incentive to invest in infrastructure that increases those values. This is clearly in the interests of the asset owners, who get the rest of the uplifts in asset values—including uplifts from projects that would not otherwise proceed.

But the uplift in site values due to infrastructure does not damage the affordability of sites for renters and prospective buyers, because the uplift is caused by improved amenity; it does *not* represent an increase in prices or rents of sites of *given* amenity. The maintenance of affordability is especially obvious if the improved amenity is realized in cash, e.g. as a saving in transport costs or education

costs. And again it is relevant that the financing mechanism enhances the bargaining power of renters and prospective buyers.

5 Specific implementation issues

5.1 Coexistence with the tax system

Entities under shared equity/tenancy contracts would neither pay income tax on their own behalf, nor remit indirect taxes, but would still remit personal income tax on behalf of any employees who are still in the old system,[2] and would still bear any indirect taxes hidden in prices that they pay—although those hidden taxes would be reduced as *other* entities opted out of the tax system and consequently stopped remitting indirect taxes.

If an entity ceases to pay a certain tax, it ceases to be eligible for deductions against the associated tax base and for offsets against the tax payable. In particular, individuals opting out of the system would cease to be eligible for income-tax deductions and offsets. All this would need to be considered when negotiating equity and tenancy percentages.

Many taxes have exemptions for certain entities and therefore require rules concerning transactions between a taxed entity and an exempt entity. Those rules continue to apply if the exempt entity is exempt by reason of having opted out of the tax system. Cases in which shared equity/tenancy contracts require consequential amendments to existing tax laws should therefore be rare.

As an example, consider the Australian GST. Enterprises under shared equity/tenancy contracts would not remit GST on their sales and, as they would "bear any indirect taxes hidden in prices that they pay", would not claim GST credits on their inputs. Consequently they would not incur any GST-related compliance costs. Such enterprises would be **exempt** in the internationally accepted terminology, or **input-taxed** in the Australian terminology. So the spread of shared equity/tenancy contracts would amount to a proliferation of input-taxed businesses, which *other* businesses would deal with according to the existing rules. If this causes political pressure to simplify the rules,[3] so be it; but shared equity/tenancy contracts do not raise any question that is not already answered by those rules.

---

[2] If personal income tax were deducted and remitted by the financial institutions into which wages and salaries are paid, *all* employers would be relieved of this task in respect of *all* employees, even if the employers remained in the old tax system. Similarly, compulsory superannuation contributions could be rolled into gross wages and salaries and then deducted by the same financial institutions, relieving employers of the task. See Gavin R. Putland, "Give banks the job of deducting tax, super", *The Age* (Melbourne), March 29, 2006, p.14. The central bank could then be empowered to control inflation by varying the superannuation contribution, instead of by varying interest rates.

[3] In Australia, a GST-registered business must treat an input-taxed (i.e. GST-exempt) supplier as if that supplier were zero-rated; that is, input credits are not claimable on inputs purchased from the input-taxed supplier, although GST *is* embedded in the prices of those inputs. This is double taxation, and causes an exception in the procedure for handling inputs. Neither the double taxation nor the exception occurs for fully taxable suppliers, and the double taxation does not occur for zero-rated suppliers. For these reasons, many GST-registered businesses refuse to deal with input-taxed suppliers. In response, hundreds of thousands of small businesses and charities that would otherwise have been eligible for input-taxed status have been forced to register for GST and incur compliance costs. The problem would be avoided if input credits were claimable on inputs purchased from input-taxed suppliers. This would mean that GST is reclaimed on the *output* prices of an input-taxed business when in fact it has only been paid on the *input* prices, so that the value added by that business escapes taxation. Logically, that is exactly what *should* happen to a business that is "exempt" from a "value-added" tax!

5.2 Home owners, charities, etc.

As home sites increase in value, the rent payable for the public share of the site value will likewise increase, but will not necessarily be matched by an increase in household income from which to pay it. (And while home owners are quite willing to borrow against their rising equity for the purpose of consumption, they are not so keen to do so for the purpose of paying government charges). However, it is possible to defer any increment in the rent payable for the public share of the site value, allowing it to accumulate as a lien against the site until the next transfer of title, and capping the lien to some fraction of the real increase in the site value since the last transfer. Ordinary home owners who opted out of the tax system would then be protected against increases in their recurrent rent bills (which is not necessarily the case with municipal rates under the present system). In a large jurisdiction with a proportionally high rate of turnover in the housing market, it might even be possible to defer the *whole* of the rent in this manner, in which case ordinary home owners would no longer get periodic bills for property taxes *or rents* payable to that jurisdiction.

Similar concessions are possible in respect of sites used for educational, charitable, or religious purposes.

At this point some readers might ask: "Why not simply exempt these sites from the category of assessable assets?" A home site, in most cases, would be the only asset with which the owner or occupant could negotiate a way out of the tax system. And while an educational, charitable, or religious institution would already be enjoying considerable tax advantages, it would also be incurring compliance costs in order to claim those advantages, and might therefore still prefer to opt out of the system altogether; but for that purpose it would need an "assessable" asset, and again the site owned or occupied by the institution would often be the only candidate. Moreover, *none* of the aforesaid owners or occupants would be forced to accept contracts whereby the assessability of their sites would become relevant; *all* of them would be free to remain in the existing system should they so prefer. In these circumstance, exempting any sites from the "assessable" category would serve no purpose but to deprive some of the owners of choice, trapping them in the existing system whether they like it or not.

5.3 Listed companies

Corporate shares are *partly* site-like because they are at least partly backed by other site-like assets—especially as regards the above-par portion of their value—and because their supply is inelastic in the short term. It would therefore be reasonable to treat a fraction of above-par component of share prices as assessable; that fraction would be specified in paragraph (8) of the Act, and would be higher for a business assessed as a natural monopoly than for one assessed as competitive. To minimize compliance costs, the rent payable on the publicly owned portion of a company's shares should be payable *by the company*, so that shareholders who opt out of the tax system are not individually assessed on their acquisitions, sales, and fluctuating portfolio values. Whether rent is payable on a company's shares would therefore depend on whether the *company* opted out of the tax system: a company choosing to pay rent on part of its share value would not pay tax in the same jurisdiction. But in jurisdictions with dividend imputation, one could notionally divide the rental payments among the shares as **franking credits**, which would be claimable by any shareholders who are still in the tax system.

Restricting assessability to the above-par component the share price would assist infant companies by exempting them from shared-equity rent (and tax, and the associated compliance costs) until their share values rose above the issue prices. Equally well, the need for current revenue from which to pay the rent on the above-par component would tie share prices to revenue, eliminating the absurd spectacle of profitless companies with sky-high share prices; this would have sufficed to prevent the

"irrational exuberance" that led to the dotcom bubble, the subsequent crash, and the mini-recession of 2000–1. Better still, the rent payable on the above-par component would be an **auto-stabilizer on share prices**: the market would know the rent implications of a high share price and would respond by bidding down the price; likewise it would know the rent implications of a low share price and would respond by bidding up the price. Wild fluctuations would thus be avoided, and the growth of share prices would stabilize around the long-term trend.

Similarly, the rent payable on the public equity in site values would prevent wild swings in the property market and stabilize property values around their long-term trends.

Payment of public rents on both the value of a company's shares and the values of assessable assets held by the company does not amount to double assessment, because the rent payable on the assets will be reflected in lower share prices; and even if it were double assessment, this would be taken into account in the negotiated percentages.

The desire to conclude a shared equity/tenancy contract with a particular jurisdiction might motivate a company to devolve its operations in that jurisdiction to a separate listed company, so that the deal would not affect operations outside that jurisdiction. If this consideration leads to a voluntary break-up of multinational companies into smaller companies with stronger national loyalties, so be it.

Listed trusts could be treated in the same way as listed companies.

5.4 Severance "taxes", resource rent taxes

Specific or *ad-valorem* charges for fishing, logging, mining, or drilling, although sometimes misnamed "severance taxes", are officially and properly called **royalties**. (If they were taxes they would also be excises, in which case the mining royalties that have long been charged by the Australian States would be unconstitutional.) Not being taxes, they are outside the scope of shared equity/tenancy contracts. This however does not mean that they are beyond reform. For example, if a mining royalty were apportioned to the reduction in the market value of the mining license due to depletion, it would no longer discriminate against miners of lower-grade or less-accessible deposits,[4] whose margins might be insufficient to cover specific or *ad-valorem* royalties.

In contrast, "resource rent taxes" or "excess profit taxes" on the proceeds of mining or drilling should be eliminated under shared equity/tenancy contracts, for four reasons. First, they are officially called taxes. Second, they add to compliance costs, the elimination of which is a major goal of shared equity/tenancy contracts. Third, they are variants of income tax, which is classified as a tax even if the income in question comes from land or other natural resources. Fourth, the elimination of any tax, including a resource rent tax, will be compensated in the negotiated percentages of equity and tenancy.

5.5 Sin taxes

If the purpose of shared equity/tenancy contracts is to eliminate taxes, then entities presently remitting tobacco excise or liquor excise or gaming taxes to a particular jurisdiction would cease to do so under a contract with that jurisdiction. This invites the question: "Shouldn't there be charges to discourage smoking, drinking, and gambling?" Perhaps, but any such charges need not take the form of taxes; for example, they could be counted as compulsory insurance premiums, and the scope of the associated insurance could be made wide enough to absorb those premiums (perhaps supplemented by others). In this way, sumptuary charges on tobacco and liquor could be taken off-budget.

[4] For this insight, and for several other improvements to the present submission, the author is indebted to Dr. Terence M. Dwyer; see his submission on behalf of Prosper Australia.

The disadvantage of that approach is that the elimination of taxes would not be entirely voluntary. But if the insurance premiums were levied on the the same base, with the same rates and thresholds, as the taxes that they replaced, the reform would be as safe as if it were voluntary.

Another approach is to leave sin taxes out of the contracts and accept the fact that the contracts would not completely eliminate taxes for those entities that remit sin taxes. While the number of affected entities would be small, the elimination of "all taxes except sin taxes" makes a less interesting headline than the elimination of "all taxes".

A third approach is to answer the question in the negative, insisting that governments should not profit from activities that they ostensibly want to discourage, and that therefore the discouragement should be by means other than taxes. In that case, sin taxes would be eliminated under shared equity/tenancy contracts.

5.6 Fuel taxes, carbon taxes

Fuel excises are taxes and therefore would need to be included in shared equity/tenancy contracts, if the purpose of such contracts is to eliminate taxes. Again the reader might insist that there be some sort of charge to discourage the burning of fossil fuels. And again such a charge could take the form of an insurance premium instead of a tax, provided that the scope of the insurance is wide enough.

However, a charge for discouraging the burning of fossil fuels need not be imposed at the point of combustion, but can be imposed at any earlier point in the supply chain; in particular, it can be imposed at the point where the raw resource is extracted from the ground or sea bed, in which case it is a royalty rather than a tax. Indeed, from the viewpoint of any single jurisdiction, it is arguably *preferable* to impose a royalty at the point of extraction. A tax on the burning of carbon in Australia does not ensure that less carbon is burnt globally, but only ensures that less of it is burnt for Australia's economic benefit. A tax on oil imported into Australia does not ensure that less oil is consumed globally, but merely ensures that Australia gets less of it. But a royalty that slows the mining of Australian coal slows the supply of that coal not only to the Australian market, but to the global market; and the coal that is not mined is not lost from Australia, but is conserved for a later date.

The options mentioned in connection with sin taxes also apply to fuel excises. If fuel excises are replaced by insurance premiums or royalties, the elimination of taxes is not entirely accomplished by voluntary contracts. If fuel excises are retained, the elimination of taxes is not complete. If fuel excises are eliminated under the contracts and not replaced by insurance premiums or royalties, then burning of fossil fuels must be discouraged by other means.

5.7 Emissions trading

Emission rights issued by any jurisdiction are clearly assessable assets within that jurisdiction and would therefore be counted in shared equity/tenancy contracts. But the more important question is whether any such rights should be issued at all. Under an emissions-trading system, government sets the cap on carbon emissions and lets the market set the price of carbon—perhaps with wild fluctuations, causing unpredictable economic effects. Under a carbon tax, government sets the price—with much more predictable economic effects—and lets the market determine emissions. The alleged environmental superiority of the former option depends on the inclusion of all globally significant emitters within the cap; if any are outside it, the jurisdiction choosing an emissions-trading system gets the disadvantages of both options and the advantages of neither. That observation strongly suggests that a carbon tax is preferable to emissions trading. But, as noted above, a mining/drilling royalty is preferable to a carbon tax.

5.8 Assessing the rent

Values of **sites** are routinely assessed for the purpose of municipal rating and other property taxation, and are easily converted to rental values. Imposing rates on the combined values of sites and buildings—an iniquitous practice which penalizes construction and extension in order to restrict the supply of housing and drive up rents—does not eliminate the need for a separate valuation of the site, because the influence of location on the value of a property is contained in the site value. Therefore, in most jurisdictions, the necessary machinery for valuing sites is already in place.

Licenses, if tradeable or rentable, can be valued by recording market transactions. **Taxi plates**, for instance, are both tradeable and rentable—or if not are easily made so by some judicious deregulation. If a certain license is already rented *from the jurisdiction* under a competitive bidding system, the jurisdiction is already collecting 100% of the rent. Does that mean an additional rent fraction can be negotiated under a shared-tenancy arrangement? Yes, because an entity that does not pay tax on the proceeds of using the license will be able to bid more for the license itself, and will need to do so in order to beat other bidders in the same situation. If "all taxes come from economic rent," the rent paid by taxpayers is net, not gross.

If the Executive Branch acquires a certain percentage of the equity in an **intellectual property** right, it takes that percentage of the royalties. The so-called "licenses" granted by IP owners are not assessable.

The value of a **natural monopoly** held by a listed company can be assessed from the total of that company's shares. In the case of a company involved in both monopoly and non-monopoly operations, a **structural separation** between the two classes of operations would assist the valuation.

In some cases it would be convenient for an asset owner to pay shared-equity rent based on its own valuation of the asset, provided that the same valuation shall apply if the asset is compulsorily acquired. Prospectuses and reports to shareholders are further sources of valuations in which the owners estimate the values of their own assets and have an incentive not to understate them.

Details not explained here are nevertheless within the competence of professional valuers and, in disputed cases, the courts; the interested reader may consult a textbook on valuation.[5]

5.9 Tax base "competition"

Experience tells us that the revenue-raising efforts of multiple tiers of government (e.g. local, state, and federal) can get in each other's way. For example, property taxes levied by the municipality or the state are generally deductible against federally taxable income; and a state income tax, if applicable, might even be **offset** against the corresponding tax payable at federal level.

No such problem would arise from multiple tiers of government collecting rent for shared equity and shared tenancy in the same assessable asset (e.g. a site). Again this is because "all taxes come from economic rent." While a government's equity share *by itself* would cut into the market price of an asset, the corresponding tax exemption *by itself* would increase the price that entities outside the tax system would pay for the asset, and the two effects would roughly cancel out. While a government's tenancy share *by itself* would cut into the market rent of an asset, the corresponding tax exemption *by itself* would increase the rent that entities outside the tax system would pay for the asset, and again the two effects would roughly cancel out. While the capitalized value of an asset is the capitalization of its net rental value, it makes no difference whether a given net rental value is "net" of tax payable by the owner and the tenant or "net" of the rent payable on the government's share of equity and tenancy, as long as it is "net" of whatever is applicable.

[5] For example, J. F. N. Murray, *Principles and Practice of Valuation*, 4th Ed. (Sydney: Commonwealth Institute of Valuers, 1969).

5.10 The broader the base…

If "all taxes come from economic rent," then economic rent is the whole tax base, and any attempt to extend the base to the rewards of labour or capital—let alone more nebulous concepts such as "consumption" or "income" or "property", each of which includes the returns to more than one factor of production—is futile.

It follows that when governments increase taxation in times of emergency, such as war, they are effectively expropriating additional fractions of the values of site-like assets, whether they admit it or not. But by admitting it, they can avoid deadweight costs and compliance costs, both of which impair the capacity to deal with the emergency. Compliance costs are especially relevant in times of war: when you need men to fight the enemy, or women to work in munitions factories, you can't afford to waste them on unnecessary tax-related paperwork.

6 Advantages for particular interest groups

(In this section, when it is said that entities opting out of the tax system would no longer pay or remit a certain tax, it is assumed that the entity is opting out of the tax system in the jurisdiction(s) in which that tax is applicable.)

6.1 Enterprises

Most taxes and some compliance costs are **marginal costs** (that is, they increase with turnover), and therefore must be recovered through prices if an enterprise is to grow. This is obviously an impediment to growth. In contrast, rent is a **fixed cost** (that is, independent of turnover). So an enterprise that accepts a shared equity/tenancy contract will replace a marginal cost with a fixed cost and thereby gain an advantage in the contest for market share.

6.2 Employers

If an employer opts out of the tax system (of a certain jurisdiction), it will no longer pay payroll tax or fringe-benefits tax (in that jurisdiction).

6.3 Employees, job-seekers

If you, as an individual, opt out of the tax system, employers need not deduct income tax on your behalf, and can more easily reward you for good performance because income tax will not eat into any raise in your wages or salary. Thus you minimize compliance costs for prospective employers, increase your opportunities to improve your lot by hard work, and signal to prospective employers that you are keen to maximize your performance.

Indirect taxes obviously feed into prices. Income tax, although usually called a direct tax, is a cost of production, and will prevent production unless it is recovered through prices. So all these taxes raise prices, adding to inflationary pressures and raising the so-called **natural rate** of unemployment, which is the minimum unemployment rate that causes enough wage restraint to give stable inflation. The central bank adjusts interest rates so as to maintain unemployment at this "natural rate". But, as more and more entities opted out of the tax system, fewer and fewer would remain subject to the inflationary taxes; so inflationary pressures, and therefore the "natural rate" of unemployment, would fall.

6.4 Exporters, local producers competing with importers

When taxes feed into prices, they feed into prices of exports and import replacements and thereby damage international competitiveness. While GST zero-rates exports, the related compliance costs still affect export prices. Domestic payroll tax raises prices of local products (including exports) more than those of imports, because it applies to labour employed locally but not to labour employed overseas. All indirect taxes, by raising the cost of living, affect wage outcomes, hence export prices.

Thus, by opting out of the tax system, domestic producers can improve their international competitiveness, helping the nation to trade its way out of debt.

The replacement of fuel excise by mining and drilling royalties, although desirable on environmental grounds, may appear to damage international competitiveness in that royalties affect the prices of domestic products but not imports, whereas fuel excises do not discriminate. But by conserving domestic resources, royalties may also have the effect of delaying their exportation until global prices are higher, thus enhancing the balance of trade in the longer term. Meanwhile, as payroll tax and income tax discriminate against domestic products relative to imports, the labour capacity that is wasted by those taxes is *not* not thereby conserved for a later time. Therefore, if any readers attack mining/drilling royalties for damaging international competitiveness, it is to be hoped that they do not also defend income taxes or payroll taxes!

6.5 Accountants, tax lawyers, realtors, conveyancers

An entire population of entities contemplating radical *optional* rearrangements of their tax affairs would obviously generate much business for the professionals who facilitate such rearrangements or give advice thereon. In particular, property investors who opted out of the tax system would see property in a new light—not only as a source of newly untaxed capital gains and rental payments, but also as a holding cost (shared-equity rent paid in lieu of tax). Hence, while increased expenditure on infrastructure would make property investment more profitable, investors wishing to take maximum advantage would need to rationalize their holdings, either generating income from their properties or selling them to someone who will. That would generate much business for the property-transaction industry.

6.6 Property owners

If a government, in consequence of a shared-equity contract, owns a fraction of the value of a site, that government has an incentive to make decisions that raise the value of the site—e.g. investing in infrastructure. This is unequivocally in the interest of the property owner who owns the rest of the value of the site.

6.7 Superannuants and funds

A superannuation fund opting out of the tax system would no longer remit income tax (including capital-gains tax, if applicable) on contributions and earnings. A superannuant opting out of the tax system would no longer pay tax on lump-sum or annual benefits, although the expectation of such benefits would obviously influence the negotiated percentages in the shared equity/tenancy contract.

Because superannuation contributions are invested partly in property, and partly in shares that are partly backed by property, the promotion of investment in infrastructure that raises site values would be in the interests of superannuants. Meanwhile the tendency of public-equity rents to stabilize asset values around their long-term growth trends would reduce the swings in the values of superannuation portfolios.

6.8 Renters and first home buyers

That the spread of shared equity/tenancy contracts would tend to raise property values does *not* mean that it would make housing less affordable. On the contrary, the holding cost on property owners would encourage them to cover that cost by building on vacant land and offering vacant buildings to tenants and buyers. The ensuing increase in the supply of housing would improve affordability.

Housing affordability is a function not only of rent or price, but also of amenity (which is improved by infrastructure) and the spending power of prospective renters and buyers (which is increased by higher employment and lower deadweight costs, i.e. higher economic output). The single variable that balances all these influences is *competition*: if property owners are encouraged to build dwellings and seek tenants and buyers, the competitive position of each prospective tenant or buyer is enhanced, so that housing must become more affordable *to that prospective tenant or buyer*, whatever happens to its rent or price in raw monetary terms.

To claim that both landlords and tenants would gain, or that both buyers and sellers would gain, is not a contradiction, because the promotion of economic growth is not a zero-sum game; it is analogous to making a bigger cake so that everyone can have a bigger slice.

Given that every benefit won by working families is competed away in the rents and prices of residential land, the only way to improve their lot is to reduce the intensity of the said competition. In other words, the only benefits that are not taken away by the housing market are those that are delivered *through* the housing market, by enhancing the bargaining power of tenants and first-time buyers. That indeed has been the overriding aim of this submission. But in a context of overall economic growth, the gains of the weak need not be the losses of the strong.

6.9 Cities, states, nations; “historical inevitability”

While opting out of the tax system would not be compulsory, it would be highly advantageous. Entities choosing this option would avoid compliance costs and deadweight costs and would therefore tend to out-compete any other entities that remained in the tax system. Furthermore, if an entity opts out of the tax system by surrendering some equity in an asset to the Executive Branch, and if the Executive Branch will retain a standard percentage of the equity after the asset is next sold, the encumbrance on the asset would reduce its value for entities inside the tax system, but not for those outside; the latter would be buying the asset subject to shared equity even if the seller were still under the tax system. Thus entities outside the tax system would have an advantage in the competition to acquire assets, and this advantage would increase as more and more assets became subject to shared equity.

For these reasons, if a jurisdiction were to give taxpayers the option of shared equity/tenancy contracts in lieu of taxation, the take-up of that option would be rapid.

Because shared-equity rents and shared-tenancy rents would not feed into prices, including prices of exports and of products that compete with imports, a jurisdiction with a high percentage of entities under shared equity/tenancy contracts would have a competitive advantage over jurisdictions with only conventional tax systems. The policy of allowing shared equity/tenancy in lieu of taxation would therefore spread rapidly from jurisdiction to jurisdiction—for the same reason that VAT, which zero-rates exports, eventually displaced wholesale taxes and turnover taxes, which do not. But the policy of allowing shared equity and tenancy in lieu of taxation would spread faster because it would be more popular.

7 Recessions and financial crises

7.1 Prevention

The officially confirmed recessions in New Zealand, Ireland, and France, and the recessions widely believed to have started in the UK and the USA, closely follow the bursting of property bubbles in those countries. The global recessions of 1990–1, 1981–2, and 1974–5 followed the same pattern. Property crashes were also implicated in the so-called Asian Financial Crisis of 1997.

The present global financial crisis is similarly traceable to the bursting of property bubbles, especially in the USA. "**Subprime**" was only the headline; it referred only to the credit-worthiness of borrowers, whose defaults would not have posed any threat to the financial system if the collateral had been good. But it wasn't, because its valuation was based on a speculative bubble, which duly burst. Moreover, the collapse in collateral values was not confined to subprime borrowers or even to the USA, and has itself been a cause of defaults. But "subprime" is a convenient headline because it leaves American subprime borrows, who are mostly poor and non-white, to take the blame for the whole mess.

Of course a so-called "property bubble" or "housing bubble" is actually a *land* bubble. Buildings, whose values are limited by construction costs and depreciation, are not worth speculating on. But *sites*, in a rational market, appreciate in line with capacity to pay; and in a rising market, rational expectations easily give way to belief in the greater fool.

The recession in Singapore (officially reported in October 2008) seems to be caused by a fall in exports, in which case it is a secondary effect of land-crash-induced recessions in other countries. The same mechanism is one of the reasons for recent Chinese attempts to delay purchases of Australian iron ore; but the main reason is probably the slump in construction following the burst of the Chinese property bubble.

The mini-recession of 2000–1 followed the burst of a bubble in another asset class: technology stocks. Under a shared-equity contract, as noted in subsection 5.3, the rent payable on the government's equity in a company's shares would stabilize the share price. Similarly, the rent payable on the government's equity in sites would stabilize market values of sites, preventing bubbles, bursts, and the consequences thereof.

7.2 Recovery

If the bubble has already burst, reducing the deadweight cost of the tax system will reduce the severity of the ensuing recession or, if the recession has already started, accelerate recovery. Allowing people to opt out of the tax system altogether, as proposed here, is the *second*-surest way to reduce that deadweight burden of the tax system. The surest, of course, is to make the exit from the tax system compulsory instead of optional; but that, in the terminology of the fictitious Sir Humphrey Appleby, would be a courageous decision.

The Australian housing bubble sprang a leak at the beginning of 2004. Under normal circumstances this would have been enough to cause a recession in Australia. But circumstances were far from normal: the housing slump coincided with a historic upturn in Australia's terms of trade, which in turn reinflated the housing bubble. Now that the global demand for commodities appears to be shrinking, Australia will suffer unless it can capture a growing fraction of that shrinking market—by eliminating taxes that feed into export prices. Meanwhile the Australian housing bubble still needs to burst. When that shoe drops, the elimination of deadweight costs will be all the more urgent.

8 Interaction with the transfer system

8.1 Equivalence of means-testing and taxation

A means-tested benefit withdrawn at a certain *rate* (the "taper rate") over a certain *base* (e.g. a certain range of earned income or of asset values) is equivalent to a *non*-means-tested benefit of the same amount plus a *tax* payable by the recipient, at the same rate and on the same base. The only difference is that in the former case the withdrawn portion of the benefit is off-budget, whereas in the latter case it is *on*-budget, causing a higher official measure of tax receipts offset by a higher official level of outlays. But in all other respects, *including perverse incentives and the associated deadweight costs*, and as seen by both the provider and the recipient of the benefit, the two systems are the same.

The recipient, in particular, is interested in how many cents from each additional dollar of earned income, or from each dollar of real or imputed income from each additional asset acquisition, will be clawed back by the government. Whether the clawback is taken by the tax authority under the guise of a tax, or by the social security authority under the guise of a means-test, or by some combination thereof, is a matter of indifference.

Readers who doubt the equivalence between means-testing and taxation might do well to consider an analogous and more widely acknowledged equivalence: tax concessions are equivalent to expenditure items for all practical purposes, except that

- tax concessions are subjected to less scrutiny, both inside and outside the legislature, and
- tax concessions are off-budget, giving the illusion of lower expenditure and lower taxation.

Similarly, means-tests are equivalent to taxes for all practical purposes, except that

- means-tests are subjected to less scrutiny, both inside and outside the legislature, and
- means-tests are off-budget, giving the illusion of lower taxation and lower expenditure.

Tax concessions are widely called **tax expenditures**. By the same logic, means-tests ought to be called **welfare taxes**. But they are not, because logic is applied selectively: while the equivalence between tax concessions and expenditure items is widely and readily admitted, the equally obvious equivalence between means-testing and taxation is stubbornly denied by multitudes of otherwise intelligent people.

8.2 Implications of the equivalence

It is often said, by commentators who ought to know better, that the abolition of means-tests would be prohibitively expensive, meaning that the required level of taxation would be unacceptably high. In view of the equivalence between means-tests and taxes, this claim amounts to an admission that mean-tests as we know them are also unacceptable—as indeed they are. They are accepted solely because they are not recognized as taxes.

Consider, for example, the tax disguised as an assets test on an age pension. This tax has a marginal rate of zero on the richest retirees, i.e. those whose asset values are above the taper range. This is what passes for vertical equity! And for retirees within the taper range, the tax is equivalent to paying interest, often at above-market rates, on one's own *savings*—not borrowings, but savings. This is how enlightened modern nations supposedly encourage people to save for their retirements!

Or consider the tax disguised as an income test on an unemployment benefit. This is equivalent to an income tax with a marginal rate of zero on the highest-income earners, and with its highest

marginal rate on the under-employed who are trying to increase their hours. In short, it is a tax on the transition from welfare to work!

The taxes disguised as income tests on various welfare payments, combined with the official personal income tax, produce absurdly high **equivalent marginal tax rates** (**EMTR**s). The manifest inequity of imposing the highest EMTRs on the working poor, while the rich indulge in elaborate legal tax-minimization schemes, makes welfare fraud the easiest of all crimes to rationalize, the more so when it is a crime of omission (failing to declare income). So the legislators typically respond by punishing welfare fraudsters more severely, in terms of both prison time and the obligation to repay, than corporate criminals who steal or lose far larger amounts. On this subject we may well quote from the fourth of Adam Smith's "canons of taxation":

> The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it; and it commonly enhances the punishment, too, in proportion to the very circumstance which ought certainly to alleviate it, the temptation to commit the crime.[6]

Of course a partial solution to high EMTRs is to allow welfare recipients to opt out of the tax system, as already proposed in this submission. For those who opted out, the contribution of personal income tax to the overall EMTR would be zero. But this would not eliminate high EMTRs caused by "stacking" of the income tests on multiple benefits, and might even be used as an excuse to introduce more such tests. That "solution" would not be complete or permanent.

The equivalence between on-budget "taxes" and off-budget "means-tests" proves that "taxation as a percentage of GDP" and "public expenditure as a percentage of GDP" have as much to do with arbitrary accounting conventions as with any facts on the ground. Further proof is Australia's use of compulsory private insurance and compulsory private superannuation for purposes that other countries finance through taxation—as if a government-mandated payment to a private entity were somehow less objectionable or less distorting than a tax. (This submission plays almost the same game in suggesting that sin taxes be repackaged as insurance premiums; the difference is that both the taxes and the premiums are unashamedly designed to be objectionable, in order to deter undesirable activities.) For these reasons it is almost meaningless to compare levels of taxation between countries, and utterly meaningless to insist, as a criterion of domestic tax reform, that there must be no increase in the overall level of taxation.

8.3 Eligibility tests; unemployment benefits

Means-tests are not the only tests that are equivalent to taxes. A benefit with an *eligibility test* is equivalent to an untested benefit plus a tax on the criterion of *non*-eligibility. In the case of an unemployment benefit, there is some overlap between "means" (income) and non-eligibility (employment).

An unemployment benefit may be resolved into two components: a **job-search allowance**, for which eligibility consists in searching for work, and which covers the cost of the search; and a living allowance, for which eligibility consists in being unemployed, and which comprises the greater part of the benefit. The "job-search allowance" component is non-distorting as it merely attaches an appropriate price to an appropriate action. But the "living allowance" component creates an artificial demand for unemployed people; and the market, as usual, meets that demand!

Many right-wing commentators would stop there, as if the demand for unemployed people were met directly by the unemployed—by refusing to work. But the ratio of job seekers to vacant positions, even in times of officially low unemployment, proves otherwise. What actually happens is that minimum wages are fixed above the unemployment benefit in an attempt to force employers to

[6] *The Wealth of Nations*, Bk. V, Ch. II, Pt. 2.

compensate for withdrawal of the "living allowance", with the result that some job-seekers are priced out of a job. If the withdrawal of the "living allowance" is understood as a tax on finding a job, the effect of minimum-wage laws is to shift the tax onto employers, with the result that they can no longer provide full employment without wage-push inflation.

If these means-tests and eligibility tests were officially re-branded as taxes, their absurdity would be immediately apparent, and public opinion would demand that the burden be spread more equitably and efficiently. If this re-branding were done immediately prior to the introduction of a scheme for opting out of the tax system through shared equity/tenancy contracts, resentment of the newly unmasked taxes would greatly accelerate the uptake of contracts. But that, by itself, would fail to rationalize the range of welfare payments, the sheer number of which makes the welfare system ridiculously complex even without considering means-tests.

8.4 Solution: A General Rebate (GR)

The only way to remove the distortion caused by withdrawal of the "living allowance" component of the unemployment benefit is to make the allowance available to employed and unemployed alike (equivalent to abolishing the tax on finding a job). Then the allowance would no longer constitute a demand for unemployed people, and employers would no longer need to compensate workers for its withdrawal; thus the cost of labour *for employers* would fall (at no cost to the workers). The result would be full employment without wage-push inflation.

But if the "living allowance" component of the unemployment benefit were extended to the employed, it would, in combination with other benefits, extend welfare eligibility to almost the entire population—in which case one might as well delete the "almost" and make universal eligibility explicit, allowing massive simplification of the system.

Accordingly, we suggest that in the jurisdiction responsible for the welfare system, any individual who opts out of the tax system should thereby enter an **alternative welfare system** with the following features:

- No means-tests;
- A core benefit, known as the **General Rebate** (**GR**), subject to a very broad activity test that would be satisfied by paid employment, or self-employment, or domestic duties, or approved voluntary work, or any combination thereof, or any of the eligibility criteria for special-purpose benefits (below);
- Special-purpose benefits including child allowances, study/training allowances, sickness and maternity benefits, carers' benefits, age and disability pensions, war service pensions, and a job-search allowance, which are payable on top of the GR, and which are largely self-explanatory in terms of qualifying criteria and activity tests.

These benefits would be funded, with zero deadweight, from shared-equity rents and shared-tenancy rents, and would be taken into account in negotiating the percentages of equity and tenancy. Thus the short-term balancing of the budget would be case-by-case. For the longer term, the calculation of the maximum standard percentages (subsection 3.6) would need to be modified so as to include the effects of means-tests and eligibility tests under "total tax". If every entity in the jurisdiction accepted a shared equity/tenancy contract on these terms, taxation as a percentage of GDP would be zero. Expenditure as a percentage of GDP might seem high, but would be funded by rents, not taxes.

Benefits similar to the GR are variously described in the literature as a "citizen's dividend" (CD), or a "guaranteed minimum income" (GMI), or a "basic income" (BI). However, the GR is *not* a

"universal basic income" (UBI), because it is subject to an activity test, albeit a very broad one which anyone would be able to satisfy; a true UBI has no activity test at all.

We envisage that the GR would be a safety net, but not a hammock; its value would be such that no economically rational person would choose to live on the GR alone. Hence the need for supplementary benefits for persons in special circumstances.

Notice that rent assistance is not listed among the supplementary benefits. We envisage that rent assistance would be rolled into the GR, and that the GR would be paid at a somewhat higher rate to a solitary adult than to an adult living with another adult. But we are highly suspicious of rent allowances that depend on the amount of rent payable. Such allowances, by definition, end up in the pockets of landlords (who are usually not in need of welfare) and allow landlords in welfare-dependent areas to charge higher rents than they could otherwise charge, thus exacerbating the problem that rent assistance is meant to solve. The absence of explicit rent assistance, like every other change in circumstances, would be taken into account in negotiating the equity and tenancy percentages.

The substitution of rents for means-tests, like the substitution of rents for taxes, would not significantly affect asset values. If the rental values of assessable assets absorb the capacity to pay, they rise when that capacity is increased by the abolition of means-tests. If the additional rent is then claimed by the Executive Branch in lieu of the means-test, the *privatized* portion of the rent is unchanged. Equivalently, the thesis that "all taxes come from economic rent" applies to taxes disguised as means-tests, and the replacement of such a tax by a public rent payment does not change the remaining private share of the rent.

9 Conclusion

If, in any jurisdiction, a taxpaying entity could avoid taxes by granting to the government a negotiated percentage of the equity in all site-like assets that it owns, and a negotiated percentage of the tenancy of all land-like assets that it occupies or uses, both taxpayers and the government would be keen to take up the option. The damaging effects of taxation on the economy of that jurisdiction would fall in synchronism with the number of entities remaining in the old tax system. Thereafter, the government would finance its expenditure not from taxation, but from rent shares, which the government would effectively have purchased by giving up its taxing powers.

Sumptuary taxes, if not eliminated under shared equity/tenancy contracts, could be replaced by non-tax royalties (e.g. mining and drilling royalties in lieu of fuel taxes) or taken off-budget (e.g. by turning excises on tobacco and liquor into compulsory insurance premiums).

In a jurisdiction responsible for a welfare system, the legislature could stipulate that an individual accepting a shared equity/tenancy contract also enters an alternative welfare system consisting of a core benefit (the General Rebate), subject only to a very broad activity test, with various supplementary benefits for persons in particular circumstances, and with no means-tests. The changes in welfare entitlements would be taken into account in negotiating the percentages of equity and tenancy. In this way the jurisdiction could eliminate *all* perverse incentives of the tax-transfer system, including not only those caused by taxation, but also those caused by means-tests and eligibility tests.

Acknowledgments

* The Land Values Research Group (LVRG), founded by Allan R. Hutchinson in 1943, is the research arm of

Prosper Australia
1/27 Hardware Lane
Melbourne, Vic 3000
Tel. 03 9670 2754, Fax 03 9670 3063.

The submission to this Review by Dr. Terence M. Dwyer, commissioned by Prosper Australia, notes in passing that an established land value "tax" is a tax only in form; in *substance* it is the rent payable on that part of the land value which is not yet privatized and therefore not yet reflected in the purchase price. The present LVRG submission takes the rent-as-revenue theme to its limits, proposing not merely a rent that is called a tax, on an asset share that the Crown implicitly retains, but rather a rent that is called a rent, for an asset share that the Crown has explicitly and honestly acquired. It will be noticed that the two submissions have broadly similar economic aims, but vastly different political frames.