DRIVING ECONOMIC GROWTH BY IMPROVING CAPITAL PRODUCTIVITY

Addressing the collapse of working capital in Australia

Australia does not have a shortage of capital, it has a problem with a large proportion of the capital in Australia being lazy, where it is not productive and does not contribute to GDP growth and employment.

Objective:
To move capital out of non-working speculative investment and move it back into working capital investments that will drive jobs and growth

Solutions 4 Strategy
Innovation for Strategic Growth

Overview

Economic stimulus policies are failing to be effective as they treat all investments the same. There are two types of investment and most investment has, unfortunately, flowed to the second type which does not create jobs or grow GDP.

1. "working" capital investment that grows GDP and jobs,
2. "non-working" capital investment that does not encourage spending or create jobs.

Australia has plenty of capital. Unfortunately it is mostly locked up in non-working assets - it is lazy capital that contributes little to the economy. We all understand that building a new house creates jobs and encourages spending, where alternatively, purchasing an existing house does little for the economy. That is the flaw with current policies, they simply encourage asset swapping at inflated prices, with little thought to encouraging investment in building business, spending or employing people. It is not rocket science that the Government needs to encourage the flow of funds from non-working capital to working capital to turn around the economy.

Cheap liquidity created by the central banks has not flowed to where it is most needed, such as business investment which grows GDP. It has instead ended up in the hands of speculators to bid up asset values. This policy has failed across the globe because central banks did not take measures to restrict liquidity flowing into working capital only.

Arguments have been made that we should not focus on GDP but rather create wealth which in turn will grow GDP. However, if that wealth is not put to work it will not grow GDP and without growth that wealth will not be sustained.

Flight from working capital

Since the GFC, there has been a flight from working capital to non-working capital such as housing at a cost to economic growth, employment and tax revenues. Even though the GFC was caused by domestic housing and share values were decimated, investors still cling to a false assumption that housing and shares are low risk. It is a fallacy that is also promoted by regulators such as APRA.

Superannuation cannot perform with non-working capital investment

Superannuation has also focused investment into the perceived low risk property and share markets. The problem with this approach is that yield cannot be achieved from such investments. Australia has most of the $1.9 trillion of pension savings invested in non-working capital and the asset bubbles they are creating through speculative growth will eventually burst.

Failure to make foreign investment productive for the nation

Foreign investment is good for the country only when it is in working capital. The electorate are pushing back because the majority of foreign investment is going into non-working capital such as taking over established farms, houses and businesses. They see a foreign takeover, not investment.

Tax reform to encourage investment back into working capital

Income taxes and consumption taxes discourage working capital investment, whilst low capital gains tax, superannuation benefits and negative gearing are encouraging speculative investment in non-working capital. Australia needs to change the tax and incentives structure to encourage investment back into working capital to drive productivity and growth. We need to ensure we reward risk takers for taking risks.

A slow economy makes income and consumption taxes a futile source of revenue. As wealth is mostly tied up in assets, capital gains taxes are the only logical solution. Negative gearing should be restricted to new properties only and super tax benefits should only apply to working capital. This is the only equitable solution to the current skew of wealth generation from non-working assets.

TABLE OF CONTENTS

Flight of capital to speculative assets at cost to GDP

Policies discouraging risk taking

After the GFC, investors and management have become overly risk adverse. There is a reluctance to invest in new products and new projects. Banks don't want to lend to business, investors don't want to be involved in new ventures.

Australia's past growth was built on the back of risk takers who developed farms in the unforgiving outback and built new industry out of nothing. This spirit has become subdued where the number of new start-up businesses have collapsed by 36% since the GFC[1] Entrepreneurs have to fight to find capital and work long hours to build up the business. The Government then punishes them for their efforts with excessive red tape and excessive taxes. The economy is now paying a price for a decade of policies that discourage business development where SME business is not growing.

The return that investors would get from investing in working capital investments comes in the form of profit that is heavily taxed. Why would investors take a risk when the Government then takes a huge cut from any rewards and when the Government never shared the risk?

Stop rewarding investors for taking the easy no-risk path

Current tax structures encourage investors to take up less risky investments in areas such as shares and real estate.   Capital gains is taxed far too low relative to the high income tax rates. We are punishing investment in much needed working capital projects whilst rewarding those who invest in nonproductive activities. The tax system is driving ruinous behavior.

Negative gearing, foreign investment and other policies fail to distinguish between taking risk in working capital and taking a safer option in acquiring existing assets.

Cheap liquidity has failed to increase GDP across the globe

Globally, countries have seen no impact on GDP and employment from cheap liquidity. Countries across the globe are struggling with over-heated real estate and share markets whilst unemployment remains high and GDP is sluggish. There has been no policy actions to channel cheap liquidity into working capital to overcome high unemployment and slow GDP.

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[1] From analysis of Australian Bureau of Statistics data in an AFR article "Red tape and taxes drive business start-ups down 36pc" 8TH December 2014

Deferred tax revenue from investing in non-productive capital

The tax department receives immediate income in the form of income tax, company tax and consumption tax from working capital investments. Where non-working capital investments such as purchasing existing property and shares defers any tax revenue down the track to when the asset is sold when capital gains tax is applied. Governments have failed to recognise that wealth generation occurring in assets instead of business development is contributing to the collapsing tax revenues through deferring revenues.

If the Government wants to reverse the collapse of tax revenues then Australia needs to redirect investment back into working capital.

Leveraging for capital gain is a systemic economic risk

Investment in non-working capital has often involved debt leverage to purchase assets that investors cannot afford on the hope that the asset will increase in value and they can sell it for more than their debt. This has led to financial disasters such as Storm Financial where investors lost their retirement savings and are now reliant on the government pension.

There is a false premise that real estate and shares are safe assets. Thirty six percent of mortgages are currently interest only, according to the ABS, and if interest rates were to rise significantly, this could result in a material increase in default loan rates. Alternatively, a decline in market values will prompt sell offs that will cause a cascading market collapse.

It is astounding that financial institutions have become involved in such proven risky activity such as leveraged investments, whilst refusing to lend working capital to small business. The current risk metrics of both the banks and APRA are seriously flawed.

There is an argument that the cash from sales of non-working capital investments will feed back into the economy. However, the reality is that there is little cash from such sales because most investments are funded by debt and most of the sale proceeds go to paying off the debt. There is little net gain in the economy from asset swapping.

Making superannuation savings work harder

There is a push to increase superannuation compulsory contributions as Australians will not have enough to retire on. However, the shortfall is damning evidence that conservative investment strategies focusing on non-working capital investment, such as shares, are not generating the returns required to meet pension targets. Instead of increasing the contribution, the focus should be on making the current investments more productive. By diversifying more into working capital projects, Australians will get greater sustainable returns on their super.

Over the last 20 years compulsory superannuation has sucked funds from working capital to put in non-working capital investments with a view on speculative profits. The economy is now starved of funds for working capital as most of the $1.9 trillion in superannuation funds is now stuck in non-working assets. Non-working capital will never maintain the sustainable returns over a period of time that working capital generates and this is undermining pension savings in the long run.

Systemic risk when liquidating speculative investments

Demand by superannuation companies for a limited supply of commercial property and shares has led to an over inflation of properties and shares. When we hit the point where baby boomers are retiring on mass, as is projected, and superannuation companies are called to liquidate assets, the tables will turn with a fall in demand and an oversupply of assets. This will drastically deflate assets at a considerable loss to pensioners. Despite having contributed for years towards retirement, these pensioners will become dependent on future tax payers due to poor investment policies of the superannuation industry.

This could happen as soon as the next 5 years and it is critical for the superannuation sector to reduce their concentration risk in these non-working capital investments immediately.

Realising pensioners asset values before they are lost

Superannuation statements show a paper value of speculative assets at current market value. As what occurred during the GFC, the paper value of retirement savings can disappear overnight. The value of assets relying on capital gain can only be realised at the time of sale and there are significant risk exposures for pensioners whose funds are tied up in speculative non-working capital.

On the other hand working capital investments deliver greater short term returns that are realised sooner and will often be more resilient to market collapse, as occurred during the GFC. Retirement savings will have greater guarantee of being realised if they are not concentrated in speculative non-working capital investments.

Tax incentives to encourage working capital

A free market does not allow the Government to dictate where investment should be made. However, it is the role of Government to rectify a market failure where funds are fleeing working capital and in doing so are having a profound impact on the economy. Government is not only obligated to address this market failure, but it has a responsibility to reverse the problems caused by Government in the first place. The flow to non-working capital is due to Government-based post GFC incentive schemes and regulatory pressures around risk, which has discouraged working capital investment and encouraged non-working capital investments.

The Government can achieve this by changing tax incentives to remove some of the benefit of investing in non-working capital activities and to increase tax benefits for working capital investments.

Capital gains tax is the best option for tax revenue

Increasing consumption tax was appropriate policy before the GFC where Governments were trying to contain spending. But in a low spending post GFC economy this is no longer appropriate. Indeed, it would be a courageous for the Government to replicate the disaster that occurred in the Japanese economy from increasing their consumption tax. In light that most wealth is in assets, it would be far more effective to increase taxes on capital wealth.

Increasing capital gains tax on non-working capital

To encourage investors to take risk and to make non-working capital investment less enticing, the Government should consider increasing capital gains tax on asset-based investments. However, the Government could maintain the current CGT rates for working capital investments, such as investment in new businesses or new buildings.

Bringing forward capital gains tax payments

Capital gains tax defers tax revenue to the time of sale. Whilst investors are benefiting from capital wealth immediately, the Government will not see tax revenues until many years into the future. It is important to neutralize the discrepancy where capital taxes are paid in the future and income/consumption tax is paid now. Whether you make a capital gain or a cash flow gain, taxpayers should immediately pay tax on that gain to ensure an equitable tax system.

It is recommended that Government tax the annual capital gain every year rather than waiting for the sale of the asset. This will bring forward tax revenues that are required immediately. This would not equate to an increased cost to investors as it would be netting off tax benefits such as depreciation and negative gearing. Exemptions could apply to owner occupied properties.

Neutralizing negative gearing

Negative gearing has become a monster that is no longer an effective use of taxpayers' funds. Despite the majority of the population having a concern with negative gearing, Governments still fear a backlash from removing it. It has now become a lavish tax avoidance scheme that is doing little to resolve accommodation shortages.

Negative gearing should only apply to new developments and should not apply to acquisition of existing properties.

By bringing forward capital gains tax revenue, the Government can offset part of the tax expense caused by negative gearing. The Government can remove the benefit for investors without legislating the removal of negative gearing, which in the long run will discourage tax payers from using this tax avoidance scheme.

Reducing super tax benefits on non-working capital

With working capital investments, superannuation tax benefits are offset by increased tax revenue they generate from the increased employment, profits and spending. However, non-working capital investments do not generate any of those tax revenue gains - and there is no offset to superannuation tax benefits.

Hence to compensate for a lack of offset tax revenues, investments in non-working capital should be subjected to higher superannuation tax rates to recover the lost income of those nonproductive investments.

Instead of focusing on the level of superannuation tax benefits provided to individuals, we should be focusing on whether the investment is benefiting the nation in growing jobs and business - or if it is parked in non-working assets.

What is the impact of bringing capital gains tax forward

There is a concern how investors and consumers will pay for capital gains taxes brought forward when the investor/consumer has not received cash from a sale. The reality is that the investors/consumers are able to borrow against increased value of assets in the worst case and those investors who can invest in shares and investment houses have the wealth to afford paying the taxes.

For a home owner with a $1M house, the annual CGT would be broadly in the range of $2K-$3K. This is relatively small compared to the repayments for a $1M house being around $57K a year and such cost could be absorbed into the loan similar to other loan fees.

This is not an additional tax, it is not a tax that is going to hurt GDP or employment. It is a tax that will have to be paid. Just as Governments have moved for individuals to "pay as you go" instead of paying taxes at the end of the year, it is only fair that Pay as You Go applies to Capital Gains Tax. We need to bring the tax revenue forward to counter the budget deficit caused by deferred tax revenues of non-working capital assets.

Investors have to contribute to the environment that grows their assets

If the economic fortune created by the Government generates significant wealth for investors through the large capital gains such as in real estate, then it is only fair that investors contribute a share of that gain back to the Government. Currently we have large sectors of the community who benefit from the wealth created by the Government, but do not contribute any tax revenue to pay for the Government services. If individuals can borrow against their increased value in their home to go on overseas holidays and buy luxury cars, then they can borrow to pay upfront Capital Gains Tax.

Conclusion

For the Government to achieve the growth targets raised at the G20, it will have to take affirmative action to reverse the flight of funds from working capital. Six years after the GFC, actions by Governments across the globe have failed to stimulate GDP. Instead, all they have done is over inflate assets such as real estate and the share market.

The failure of economic policies post GFC has come from Governments not restricting cheap liquidity to working capital investments. The incentives should have been structured to direct funds into working capital to grow GDP and should have been excluded from non-working capital investments.

Due to limited working capital available, companies have been constrained in growing profits and growing employment, leading to a decrease in tax revenues and higher social security payments.

Through a focus on working capital the Government will benefit from:

- increased tax revenues;
- increased GDP;
- increased employment; and
- reduced volatility in asset values

Voter reaction will be more positive

Voters are greatly concerned with job security and there is decreasing consumer confidence. Actions that are focused in rebuilding business will have support of voters. Share values and house values are of little benefit to most voters as they need to pay bills today. Income generation is of greater concern to most families struggling to make ends meet.

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Solutions4Strategy works with the retail banking sector, start-ups and cooperatives assisting with strategic planning, regulatory reporting, technology innovation and risk management.

Solutions4Strategy has been in a unique position of observing the SME funding crisis from both the business owners' perspective and the investor/lender perspective, and in doing so have been pursuing strategies to resolve the current funding crisis that has been hindering economic growth and employment. Solutions4Strategy has likewise been involved in innovation including digital disruptors such as peer to peer lending, crowd funding and other technologies.

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Solutions 4 Strategy

Solutions4strategy is focused in innovative thinking and strategic planning. We specialise in lateral thinking to identify strategic and innovative solutions to problems that are hindering growth and business performance.