Submission to the 2015 Tax Enquiry

By

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All taxes should be replaced by taxes on economic rents

What is a tax on economic rents?

What is an economic rent?

There are many definitions, but a useful one is that economic rents are excess returns above the normal levels that are generated in competitive markets. More specifically a rent is a return in excess of the resource owner's opportunity cost[1]. Thus a rent is a flow variable, not a stock variable, and is a form of income.

A tax on economic rents is a very simple tax. There are three sorts of taxes on economic rents:

1. A Tax on Economic Rents of Business Activities

The economic rent tax base (and a measure of the value of economic rents) for **business activities** is[2] –

Total revenue less all current deductions (the same as the current business/corporate income tax)

Except

1. **All capital expenditure is deducted at the rate of 100%**

2. **Interest payments are NOT deductible.**

For a business ALL capital expenditure is 100% deductible, including shares, property, anything.

But if the taxpayer decides to sell an asset previously 100% deducted, the total sales value of that asset is treated as revenue (not capital gains). This is why the economic rent tax is sometimes called (by inferior text books) the "cash flow tax", though that is a misnomer as you as not really taxing cash flow, but economic rents, economic rents….

It has been suggested, though not completely proved, that if money is borrowed at a rate of interest and the same amount is re-lent at a higher rate of interest, the borrowing interest may be deducted from the lending interest. This is because the difference could be an economic rent.

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[1] Robert Tollinson "The Economic Analysis of Rent Seeking", with R. Congleton, London, England: Edmund Elgar, 1995.

[2] The economic rent tax is derived from the so-called Brown Tax, described by Ross Garnaut and Anthony Clunies-Ross, 1983, "Taxation of Mineral Rents", Clarendon Press, Oxford, and subsequently described many times, including in the Henry Tax Review.

Thus for Banks, interest paid on borrowings could be deducted from the interest received on lending. The rest of the interest received is of course economic rent.

That's all. A very simple tax.

2. A Tax on Economic Rents of Employment Income

You can also have a tax on economic rents for **personal non-business income, including income from employment,** by taxing the personal income economic rent tax base.

This is measured by defining the personal income economic rent tax base as the economic rents obtained by employment income above a threshold of income where no economic rents are accrued in that particular activity.

This threshold income can be defined arbitrarily as a "basic wage" of the lowest paid worker, or it can be found empirically – a wage level at which no discernable economic rents are accrued.

Thus this threshold wage level will be tax-free. Anything above this threshold income will be taxed.

The personal income economic rent base is defined as total income less the threshold income.

The tax rate can be progressive. Indeed it will be progressive even with a flat tax rate because of the tax-free threshold.

3. A Tax on the Economic Rent Component of Land Values

The third tax which is axiomatically a tax on economic rents is a tax on land values - the **"unimproved land value tax".** Note that I have not just said a "land tax". Much land, for example in the middle of the Nullarbor, carries no economic rents, and taxing that land at the same rate as in the middle of a city is economic nonsense. It must be stressed however, economic rent is a FLOW variable, and what you are actually taxing with the unimproved land value tax is the economic rent income component derived from the ownership of land.

However -

In order to tax the unimproved land value base, take the total value of the property and deduct the value of "improvements", that is the value of buildings on that land, or in the case of rural properties, fences, pasture improvements, and so on. Once this is done, you get the unimproved land value.

The next step is to estimate the rate of return from that unimproved land value. This is the "economic rent". You then tax a component, or indeed what Henry George wanted, all of this economic rent.

Such a tax, assessed at a rate up to the value of the risk free rate of return[3], on unimproved land values is a tax on pure economic rents.

Requirement of a separate treatment for each type of tax

As you can see, while there is a single concept of economic rents, there are three ways to tax it, depending on the source of those economic rents. This source is obvious in most cases, but there can be confusion where a person operates a business between what is business income and what is personal income.

Under a Tax on Economic Rents, units operating a business have to be identified, and separated from the owner's personal income, and then businesses have to be taxed separately using the business economic rent tax.

I will give an example. Many doctors operate their practices on their own. Their practices are a business. Yet they draw personal income from their practice. With the current income tax the practice income and their personal income can be treated as one.

With an Economic Rent Tax, the practice business income and expenses have to be clearly separated from the personal income. The practice business can deduct capital expenditure at 100%, and not deduct interest. The doctor can draw income from the practice business, and deduct this withdrawal of income from the business as an expense. He will then be taxed separately on his business to his private income with the economic rent tax on each type of activity.

Can you deduct interest payments from personal income? There is no theoretical prohibition, but my preference is not to allow **any** deductions for personal income.

The above is a very basic description of the tax on economic rents. The description will be elaborated and questions answered in detail later in this submission.

[3] Henry George, in his book "Progress and Poverty", published 1879, advocated that the values of unimproved land should be taxed to zero. He quite correctly pointed out that the land economic rents would then be re-distributed to incomes, and poverty would be vastly reduced.

Prologue

The arrangement of this submission is in the form of a simplified economic argument and analysis. There will be many who will see all the diagrams and their eyes will glaze. There will be a few who would argue that there should be a lot more mathematics and proofs! I have chosen the bare minimum level of economic argument understandable to a well-educated non-economist. Furthermore I have chosen an economic argument rather than the usual bombastic case put in by accountants, lawyers and lobbyists "I want this, I don't want that" as I am aiming for a tax structure that benefits all, not just for those who write their submissions.

Reasons for tax enquiries

Over the years governments have held tax enquiries for just two reasons:

1. Governments are under pressure, usually from business pressure groups, to transfer taxes from themselves to other areas.
2. Governments are under pressure to increase expenditure on new areas of activity, or maintain expenditure in difficult times on areas that it was previously agreed to continue to spend money on.

Both these pressures can be simultaneous.

It is a rare, even non-existent motive that governments conclude that certain taxes are "inefficient" and desire to find alternative forms of tax, or despite protestations, wish to improve the design and efficiency of taxes. Old and inefficient taxes, unless the plucked geese hiss really hard, tend to last forever.

I hope that this enquiry gets away from elaborating and permutating all the old taxes, same old, same old, and recommends a single simple tax. Since the economic rent tax is the ultimate tax base, (called in economic circles the "ideal tax") there would be no loss in revenue if an economic rent tax was implemented to replace all other taxes, with significant and very important efficiency gains, and we can get away from this foolish and nonsensical idea that we have to "spread the taxes around". Ultimately incidence (a concept to be discussed later) makes all taxes a single tax anyway, but the process of incidence introduces a great deal of inefficiency.

But a major advantage of an Economic Rent Tax is the major increase in revenue, caused not by increasing the tax rate or taxing what was not taxed before, but regaining the losses to the economy caused by the so-called "Excess Burden" (to be discussed later) invisibly lost to the economy. This amount has been valued by researchers at least 20% of the total tax revenue raised.

A criticism of the Treasury's Discussion Paper.

The Treasury published a number of charts showing whether Australia is above average or below average in various categories of revenue raised in the OECD, and whether this proportion is above or below that of various countries. This information, while interesting, indeed amusing, is totally irrelevant for the construction of an efficient tax system. So we have higher corporate tax rates than Moldavia. So what? The aim of this enquiry should be to select the best and most efficient tax system for Australia, a tax system that has the least adverse effects on the Australian economy. What other countries do is irrelevant. In fact if they are our competitors they should be encouraged to continue their inefficient tax systems.

There is another issue regarding the plethora of these charts. There is an implication that the best tax system is that where the tax is raised from as wide a selection of sources as possible. That belief is complete nonsense, yet it is highly prevalent, even among certain economists. This belief was promoted by certain economists dating back to the 1950's, who also promoted another myth that consumption taxes are necessary and good.

These and other false and outdated beliefs are dealt with later in this submission[4] .

[4] I have a particular aversion to a certain paperback "Musgrave and Musgrave", known in the economics trade as "mistake a page Musgrave". Now fortunately out of print. This book is used by various people to make themselves instant experts in taxation economics, and it keeps cropping up, being quoted in outrageous and nonsensical statements as the revealed truth. From time to time in this submission I will not be able to refrain from referring to some nonsensical statement derived from it.

Tax as a cause of unemployment

One result of tax inefficiency is the creation of major unemployment, yet in many years of my experience these tax enquiries show that there has always been a blithe unconcern about the issue of unemployment caused by taxation. This is despite there being a long history of the malign effects of taxes on unemployment and economic activity going back to the French Revolution and before. I have yet to see, in Australia at least, a demonstration of any major concern regarding the possible malign economic effects of the imposition or continuation of a certain tax.

The imposition of the Goods and Services Tax (GST) is an excellent case in point. It was imposed without the slightest reference by the government during its "conversation" with the public, to any adverse employment effect of this tax on the economy. As a result of the imposition of the GST, the imposition was followed by a predictable immediate increase in the unemployment rate, and the economy was only saved by the arrival of the resources boom[5]. Now the dissipation of the resources boom is returning us to status quo ante of a high unemployment rate caused by an inefficient tax system.

Another example of the adverse effects of a major tax rise in Australia is the sudden rise in unemployment in the 1970's, at least partly caused by the sharp rise in taxation in that period in order to pay for Medicare (the Medicare levy). This rise in unemployment was only cured by a major improvement in efficiencies during the 1980's, created elsewhere in the economy.

I believe that modeling of the unemployment creating effects caused by a five percentage point rise in GST was done in early 2015 by a university. This modeling was sponsored by both a Government Department (not the Treasury), and by a major retailer. Maybe the Committee could obtain copies of these reports? I believe the modeled increase in unemployment was in the hundreds of thousands. (Well actually, about four hundred thousand).

[5] About a couple of years later the Treasury published a study of the effects of the introduction of the GST titled "Preliminary Assessment of the Impact of the New Tax System". It noted an increase in the unemployment of 0.8 % in the first year followed by a rapid recovery, and noted that the adverse effects had washed through the economy in about three years. However this effect was on the background of a trending fall in unemployment before that period and the introduction of the resources boom. In other words, without the GST, unemployment would have fallen, not risen in that period.

A discussion of basic tax theory

The discussion of tax theory falls initially roughly into two areas:

1. Equity
and
2. Efficiency

Tax Equity

While those unfamiliar with the subject of taxation tend to gravitate to discussion of equity and fairness and this is an area that has generated a great deal of work; in the end despite a lot of effort there was never much of a resolution, and eventually the work on tax equity petered out.

This approach foundered on something central. The empirical estimation of the rate of decline of the Marginal Utility of Money. If the utility of money does not decline as you get richer, there is no rational economic argument for redistribution from the rich to the poor. All those arguments for redistribution boil down to the "Robin Hood" arguments of one sort or another (exploitation, its not fair).

Empirical work, which is too extensive to describe here to describe in detail, but the Committee's own researchers can confirm, has indicated that there is little decline in the marginal utility of money as wealth increases. Those concave curved utility functions loved by equity theorists are actually nearly all straight.[6] The theoretical underpinnings of various proposed equitable tax systems are undermined.

Furthermore it was found that if the question of the *efficiency* of a tax was neglected when imposing an ostensibly fair tax system, those worse off usually suffered from the tax system change far more than they gained from imposing an ostensibly fair system (such as the VAT, or even increasing tax rates on higher incomes – the poor lost far more as a consequence). When this was realized work on equitable tax systems petered out. Tax equity is now of minor academic interest, various economic fossils recommending only arbitrary attempts to improve equity with unknown efficacy.

Due to lack of space, and the need to prioritise, this submission will concentrate on the subject of tax efficiency.

[6] For example, R. Layard, G. Mayroz, S. Nicholl, 2006, *"The Marginal Utility of Income*", CEPDP, 784, Centre of Economic Performance, London School of Economics.

Tax efficiency

All taxes have a different structure. As will be shown in the following sections, all taxes (except taxes on economic rents) have an inefficient structure.

Why this concern about the efficiency of a tax? Taxes cause harmful effects on the economy in four ways.

1. The sheer quantity of money and resources removed from the economy can be harmful if it is not directly returned. If in the extreme suppose some foreign power imposed a tax on Australia, removed every last dollar of the tax and did not spend the money in Australia, the depressive effects would without a doubt be very harmful for Australia.
    a. Such a situation is not fanciful. It happens in Australia today. The fact that 70% of all GST revenue raised in Western Australia is currently spent outside that State can only be very economically depressing for WA, much more so than both the State and Federal Governments seem to realize.
2. Even if all the money raised is spent in the same jurisdiction, the question is whether the money is spent in a "wasteful" and economy reducing way. This is strictly not a question of taxation per se, but of the performance of the government and how it spends the tax money. The question is that whether the tax money raised should have been better left in the hands in the taxpayer, when it could have been more employment and economic activity creating.
    a. Yes, it is argued that many activities can only or best be provided by government. But that is not directly a subject of the structure of taxation, just the size of it, and I refer the reader to the many large books on public sector economics for an extended discussion on what is, and what is not, a suitable activity for government expenditure (from the strictly economic point of view).
3. The tax collection process alone costs money, and as it does not directly generate wealth, it is a direct cost on the economy. These losses will be discussed in brief in the following section.
4. Finally, not all taxes are the same. Some are more inefficient than others. This is the subject of this submission. There are a number of measures of the economic efficiency of a particular tax. These are discussed here; and a totally efficient tax is proposed, the economic rent tax.

Why be concerned with tax efficiency?

Before going into the measures of tax efficiency, it is important for the focus of this tax enquiry that there should be a discussion of why tax efficiency is a very important subject.

Tax efficiency is not a ho-hum economically theoretical issue. Inefficient taxes directly raise unemployment by amounts measured in the hundreds of thousands of unemployed. Regardless that the same amount of tax raised is poured back into the economy in hopefully none harmful expenditure with relatively high multipliers.

Measures of tax efficiency

Tax efficiency can be divided into two areas

1. Collection and compliance costs
2. Theoretical inefficiencies

Collection costs

Collection costs are something everybody understands. "That bloody inefficient Tax Department". Some taxes are relatively low cost to collect, others much higher. But taxpayers do not need much convincing that these costs exist, and that they are significant.

In 2010, the Treasurer published the report "Australia's Future Tax System". In it he said, to quote "In 2006-07, the administration costs of the ATO and state revenue offices were around $2.9 billion, or 0.9 per cent of the revenue collected. In 2006-07, the administration costs of the ATO and state revenue offices were around $2.9 billion, or 0.9 per cent of the revenue collected."

Since then not much has changed. However this amount pales into insignificance compare to the value of the so called "Excess Burden", to be discussed later, which works out around 20% of total revenue – caused by our structurally inefficient tax system. I have consigned collection costs to a relatively small issue, and will not discuss it further, though I must point out that an Economic Rent Tax is massively simpler than the current aggregation of inefficient taxes, and will cost vastly less to collect.

Compliance costs

To quote "Australia's Future Tax System" again, "Only two major studies of the costs of complying with the main Australian Government taxes have been conducted in Australia. These were the ATO-commissioned study by the Australian Taxation Studies Program (ATAX) (Evans et al, 1997)[7] based on 1994-95 survey data, and an earlier study led by Jeff Pope based on 1990-91 data (Pope 1992)[8]. There has been no aggregate study of compliance costs in Australia since The New Tax System and the Review of Business Taxation reforms were implemented.

The ATAX study found total taxpayer compliance costs in Australia in 1994-95 to be around 1.4 per cent of GDP, slightly less than the Pope study, which estimated total taxpayer compliance costs to be 2.1 per cent of GDP in 1990-91 (Table 11.1). The ATAX study found significant differences in compliance costs as a percentage of revenue collected between individuals (4.0 per cent) and businesses (9.4 per cent). It is unclear

[7] Chris Evans, 1997, "Costs of Taxation Compliance", Australian Taxation Office.
[8] Jeff Pope, 1992, "The Compliance Costs of Taxation in Australia: an economic and policy perspective", Policy, Winter

how representative these estimates might be of existing compliance costs because of subsequent changes in the structure of the tax system and the likelihood that survey respondents may not differentiate the incremental cost of tax compliance from other costs, such as those necessarily associated with running their business.

Table 11.1: Survey estimates of aggregate taxpayer compliance costs in Australia

	ATAX[(a)]		**Pope**	
	% GDP	**% Tax revenue**	**% GDP**	**% Tax revenue**
Personal taxpayers	0.34	4.0	0.96(b)	9.2(b)
Business taxpayers	1.02	9.4	1.14(c)	6.6(c)
All taxpayers	1.36	7.0	2.10	11.9

1. All Australian Government taxes administered by the ATO.
2. Personal income tax.
3. Employers' PAYE and PPS collections, fringe benefits tax, company income tax and wholesale sales tax.

Generally, small businesses face a higher compliance cost burden relative to the amount of tax they pay than large businesses. For example, the ATAX study estimated that small businesses incurred half of tax related business compliance costs, while contributing only around 13 per cent of business tax revenue.

There are no reliable estimates of the costs incurred by transfer recipients to gain and maintain eligibility for payments, or the costs incurred by business in complying with requests for information under the social security law." End quote.

Excess Burden works out around double the relatively high compliance costs. Again, as the Economic Rent tax is so simple (there is a simple definition for profits, and personal tax deductions are reduced to an absolute minimum), compliance costs will be vastly smaller.

Theoretical inefficiencies

Just because tax inefficiencies are theoretical, it does not mean that they cannot be measured. Furthermore these costs can be shockingly large.

The two measures of theoretical inefficiency of taxation are “Incidence” and “Excess Burden”.

Incidence

What is the definition of Tax Incidence?

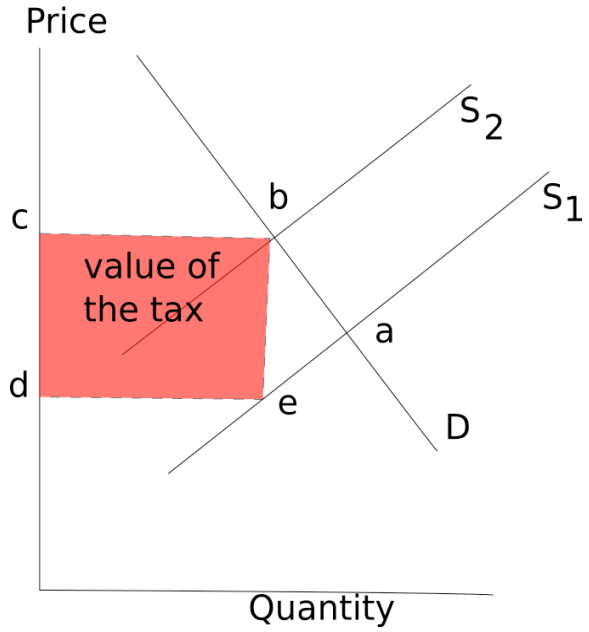
“Tax incidence is an economic term for the division of a tax between the buyer and the seller.” Investopaedia.

Analysis of Supply/Demand curves

The following is a technique that illustrates the application of tax theory using basic diagrams of Supply and Demand.

These diagrams, for those who are not familiar with them, consist of two axes. The vertical axis is conventionally the Price axis. The horizontal axis is conventionally the Quantity axis.

The Basic Supply/Demand Tax Diagram



The Demand line (denoted in the diagram by D) is most simply drawn as a straight line , going downwards from left to right. This means that as the quantity of the good increases, the price paid per unit decreases.

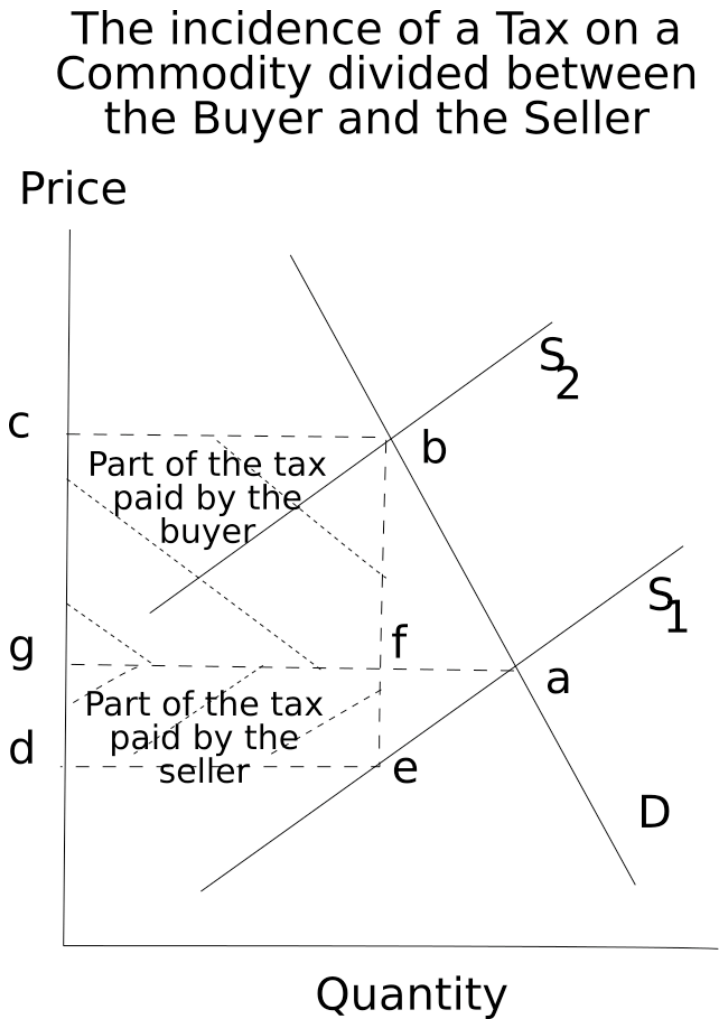
The Supply line (denoted in the diagram by S) is also most simply drawn as a straight line, going upward from left to right. This means that as to price increases, the quantity supplied increases.

These lines are made to cross, and the crossing point is called the equilibrium price.

When a tax is placed on a commodity, such as a sales tax, the price of the Supply increase per unit quantity. This causes the Supply line to move upward parallel from right to left. The Supply line moves from S1 to S2.

Now the tax per unit is the vertical distance between the Supply lines S1 and S2. It is the distance in this diagram EB. The total quantity of goods sold after the tax is applied is the distance in this diagram ED. Thus the total value of the tax is the shaded area, the tax per unit times the quantity of goods sold, or the area of the rectangle EBCD.

Simple. But that is not the end of the story.



If you draw a horizontal line from A to G through F you split the area of taxes in two, though not necessarily equally.

The bottom rectangle EFGD is that part of the tax which is paid by the seller. The top rectangle FBCG is that part of the tax which is paid by the buyer.

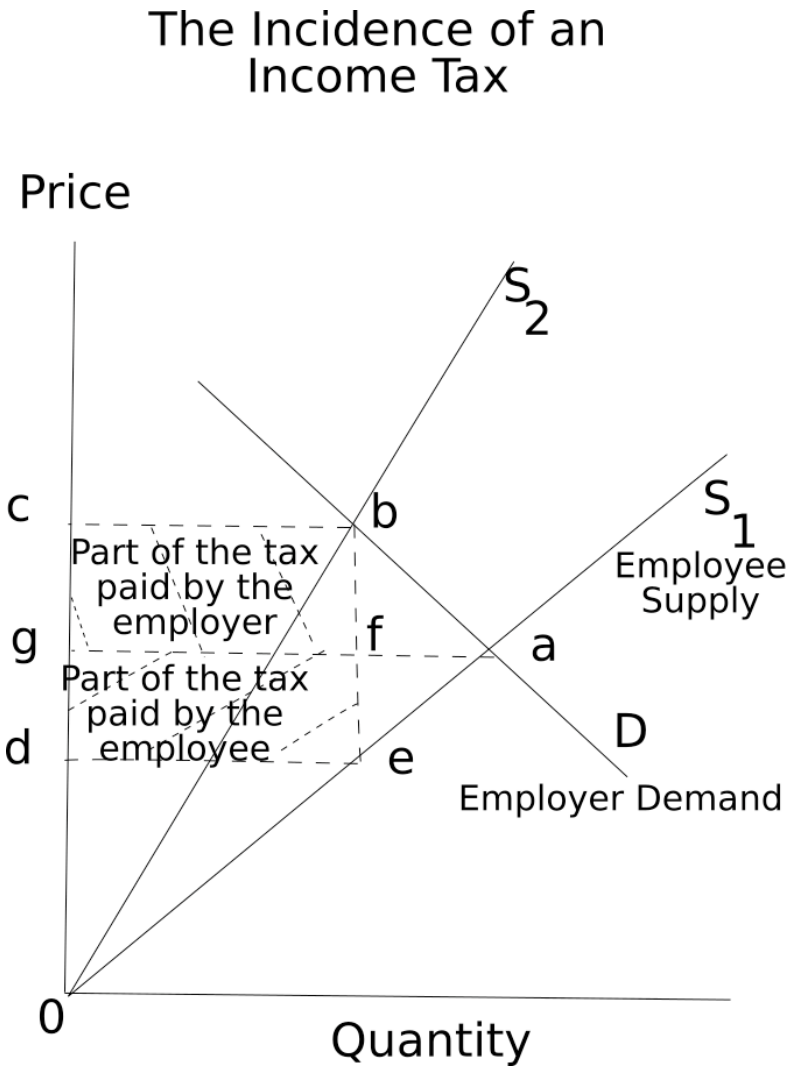
This division of taxes is called the "incidence" of the tax.

The essential point to remember is that, unlike the usual assumption by all non-economists, the buyer does NOT pay all the sales tax. Part of this is passed onto the seller The tax per unit BE is divided into two parts: that which the seller pays, FE, and that which the buyer pays, FB.

Incidence is an important component of taxation. The lesson is that those who *nominally* pay the tax are not those who *actually* pay <u>all</u> the tax.

The following is a different sort of diagram, showing the taxation of income.

Here again the supplier is taxed (the employee), but we assume a progressive tax, where the rate of tax rises from zero to whatever. (These diagrams can be designed of all sorts of scenarios). The Demander is the employer.

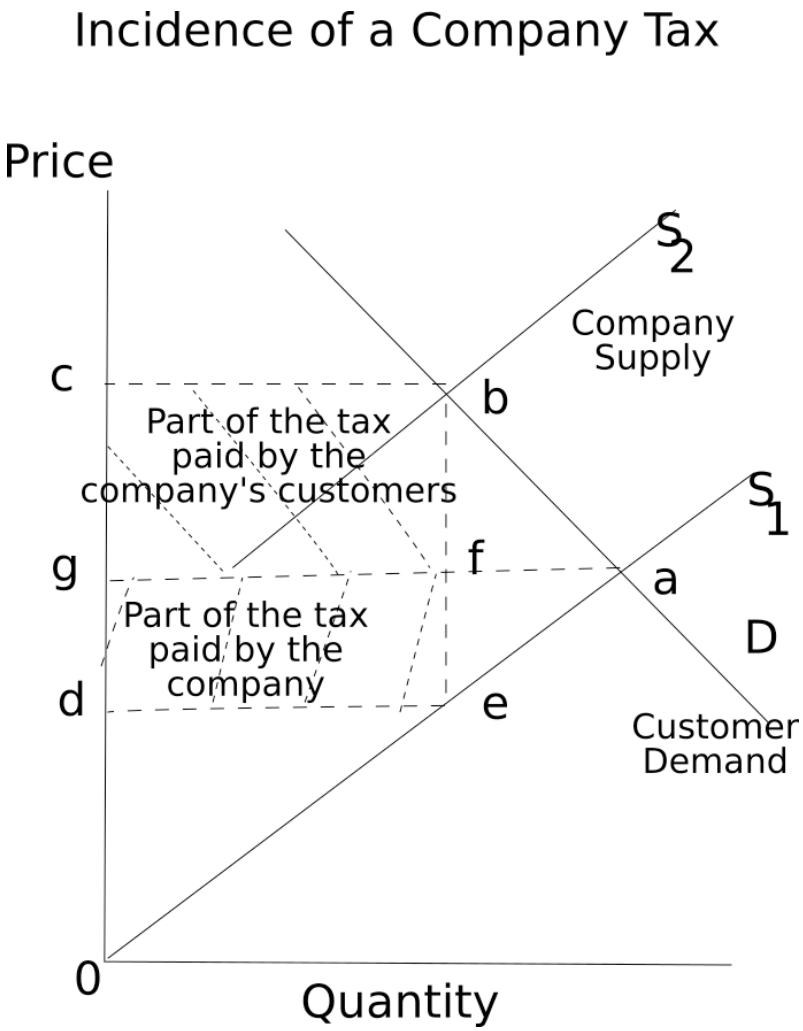


Again as can be seen, the tax is length EB at point B, total tax EBCD. But the income tax is divided between the employer and the employee. The employee pays EFGD and the employer pays FBCG.

Corporate taxation? If a corporation tax is imposed on a company it increases its average costs, which increase the company's marginal costs, which in turn could shift the firm's Supply line upward. The nature of this shift depends on the firm's pricing policy. (It is a myth that the marginal cost curve is the firm's supply curve – that depends on pure competition and decreasing returns to scale).

Thus the effect of a corporate income tax is more or less the same as the diagram of the tax on a commodity. The corporation, the supplier, pays the proportion EFGD of the total

tax EBCD and the corporation's customers pay the proportion FBCG. In other words, the corporate income tax is split between the corporation and its customers.



Incidence and elasticities

So what is incidence? Incidence is the technical name for "tax shifting". If a tax is imposed on a certain taxpayer, the taxpayer is able to shift part of the tax onto somebody else. This is done by price changes in the economy and not consciously by the taxpayer. Thus if the taxpayer is fortunately situated, even if he/she nominally pays the tax, part or nearly all of that tax is recouped from other buyers and sellers by the effect of price changes. The size of this tax shift depends on the hidden market power of the taxpayer.

How much of this tax is shifted? The proportion of the tax that is shifted depends on the slope of the supply and demand curves. If a commodity or income tax is imposed, if you have a nearly vertical Supply or Demand line, a high proportion of the tax stays with or is shifted to the one with the most vertical line. (I could provide another diagram to show

this, but I am trying to keep this submission as short as possible. Get your advisers to draw further explanatory diagrams as needed).

In economic parlance these slopes are called ‘elasticities’. A near vertical slope means that supply or demand is inelastic. Essentially if Supply or Demand is inelastic, quantity changes are unresponsive to price changes.

The horrible example of Woolworths

Non-economists tend to smile at the term elasticity. But elasticities and inelasticities have serious consequences. I shall give an example. Take the example of Woolworths. Woolworths’ customers have a very elastic (price responsive) demand, but Woolworths itself has a very inelastic (non price responsive supply – it will supply the same quantity at whatever the customers are willing to pay). So what happens to a GST imposed on the goods it sells? The major part of the value of the GST is passed from the customers (with elastic Demand), on which it is exacted, onto Woolworths (with inelastic supply).

But that is not the end of the story. Woolworths has suppliers. As Woolworths’ suppliers are many and competitive, Supply to Woolworths is very elastic. That is the Supply line is nearly flat.

It is likely that Woolworths’ Demand line is a lot more inelastic, as it can be a lot more discriminatory about the prices it offers. Woolworth’s Demand line is more steep.

Now as Woolworths has effectively incurred a loss of income due to the GST (it was not able to push the prices up to cover all of it), it passes this on to its suppliers by offering reduced prices. Woolworths Demand line falls to the left.

Now the incidence of the price fall can be worked out. It has interesting effects. While the lower ‘rectangle’ is still the suppliers, and the above ‘rectangle’ is still the buyer, the role of the elasticities reverses. The sellers, even though they have the more elastic Supply line, now absorbs a higher proportion of the price fall. The buyer, (Woolworths), even though it has a more inelastic Demand line, absorbs a smaller proportion of the price fall imposed by the GST. (Thus it does make a small loss).

So in this case Woolworths manages to pass on most of the GST to its suppliers. (Remember the sellers’ (Woolworths’ suppliers) rectangle is the bottom one and Woolworths’ buyer’s rectangle is the top one).

This is the hidden reason why Woolworths’ suppliers’ prices and profits are squeezed, and there are so many squeals and complaints. Despite the suppliers ostensibly passing the GST up the supply chain, it is then passed back down the supply chain to rest on the original supplier.

If a GST of 10 per cent is charged on fresh food, the effect on farmers' profits will be horrendous. They WILL certainly see a near 10 per cent drop in prices in goods supplied to the major stores.

The introduction of the GST is the consequence of accepting bad and (mistakenly) self-interested advice based on outdated textbooks and an idiot paperback. The manufacturing members of the Business Council of Australia (which promoted this tax) in the end now pay most of this tax in actuality, not the consumers!

Is there any way to stop this form of inefficiency? Yes there is. As will be shown later in this submission, a tax on **economic rents** has **no** incidence effects. Why? When you are taxing economic rents you are not really taxing income, you are taxing a different animal, an economic rent. The supply and demand lines does not shift, and so you cannot get any incidence effects. The tax stays with the entity that actually pays the tax, and cannot be passed on.

Furthermore this *tax shifting* carries inherent cost. While the costs of the *process* of shifting taxes have not really been measured, though they are likely to be high, the costs of taxes in an inefficient configuration have been estimated, and these costs are substantial. These costs come under the heading of "Excess Burden".

Excess Burden

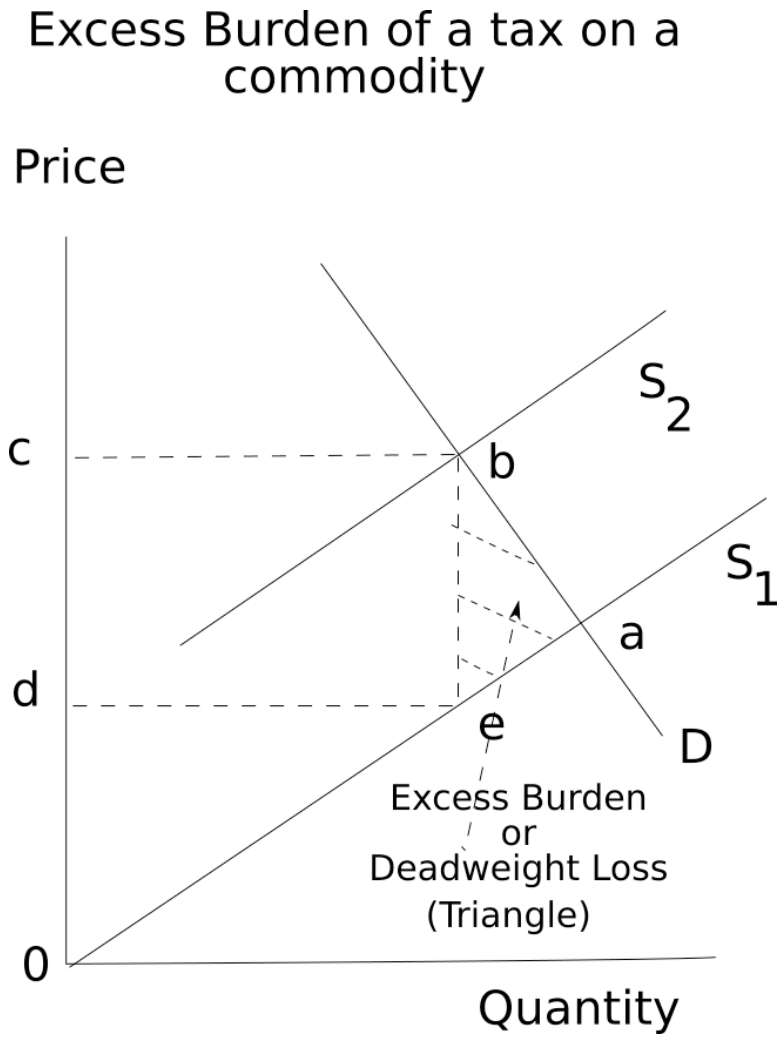
What is the definition of Excess Burden?

"Loss of economic activity due to the imposition of a (structurally inefficient) tax compared to a free market with no tax." Farlex Financial Dictionary, 2012, Farlex Inc.

The theory of Excess Burden goes back to Hicks, but the two current major authorities are Auerbach[9] and Feldstein[10], who have each written many papers on this subject. Two examples are given in the footnotes below.

So what is Excess Burden, otherwise known in the literature as the Deadweight Loss? I again turn to the diagram previously described for the Incidence Effect.

[9] Alan J. Auerbach and J. R. Hines, 2001, "Taxation of Economic Efficiency", National Bureau of Economic Research, NBER Working Paper 8181.
[10] Martin Feldstein, 2008, "Effects of Taxation on Economic Behavior". National Bureau of Economic Research, NBER Working Paper 13754.



This time, instead of looking at the rectangle on the left, I refer you to the triangle to the right of this rectangle. This triangle is called the Excess Burden or the Deadweight Loss.

So what is happening in the above diagram?

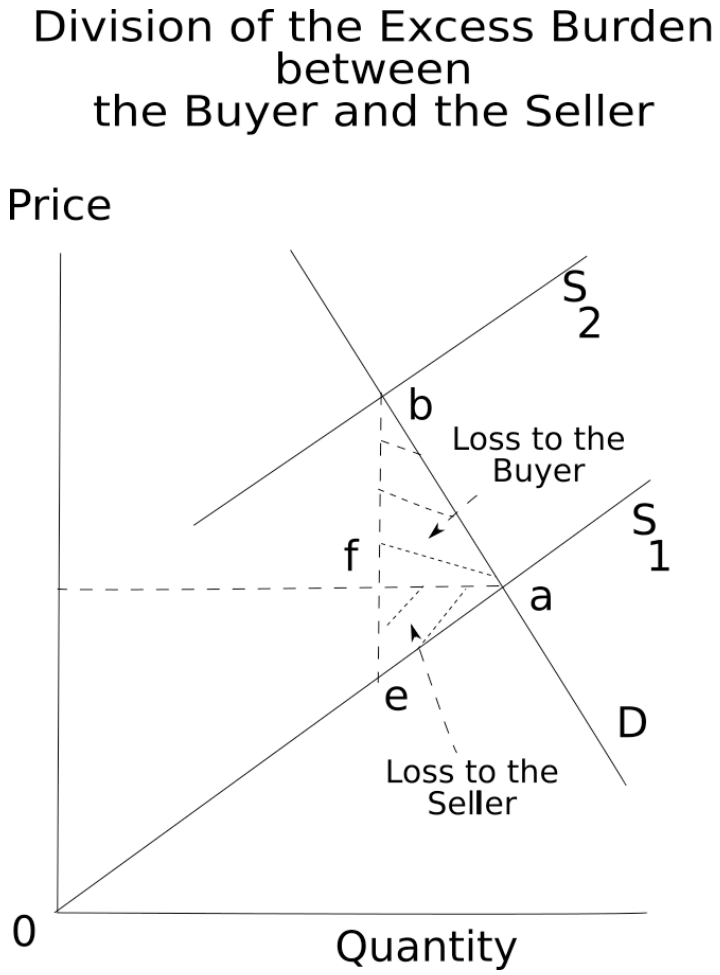
In this example a sales tax is imposed, such as a GST, at an amount EB. This has the effect of moving the Supply line up from S1 to S2, as the cost is increased. Aside from the incidence effects described in the previous section, the tax causes the loss triangle ABE.

As can be seen from the above triangle, these losses are not negligible. In this diagram it is about 20 per cent of the total tax paid.

Now I often get asked “What does excess burden mean to me. I instinctively understand tax shifting, but how does excess burden affect the butter on my turnips?”

I reply “As the definition says, Excess Burden is a loss of economic activity. In other words economic activity is reduced, economic growth is reduced, and you may even lose your job as a consequence. Excess burden is not nice, it is real, and it can have major nasty effects that can impact directly upon you.”

This Excess Burden is a hidden loss to the economy. It cannot be directly measured in terms of tax dollars, but there are methodologies available which can indirectly estimate this amount. But, even though the Excess Burden loss appears “theoretical” it has a very real loss on the economy, and this amount can be estimated. Its effect is just like the tax imposed by the enemy power discussed earlier, it is money and resources taken from the economy and it is not returned. Unlike most taxation, Excess Burden is a net loss to the economy. Thus the effect of a 20% Excess Burden is far more serious than a tax imposed on the economy, as the tax is normally paid back into the economy.

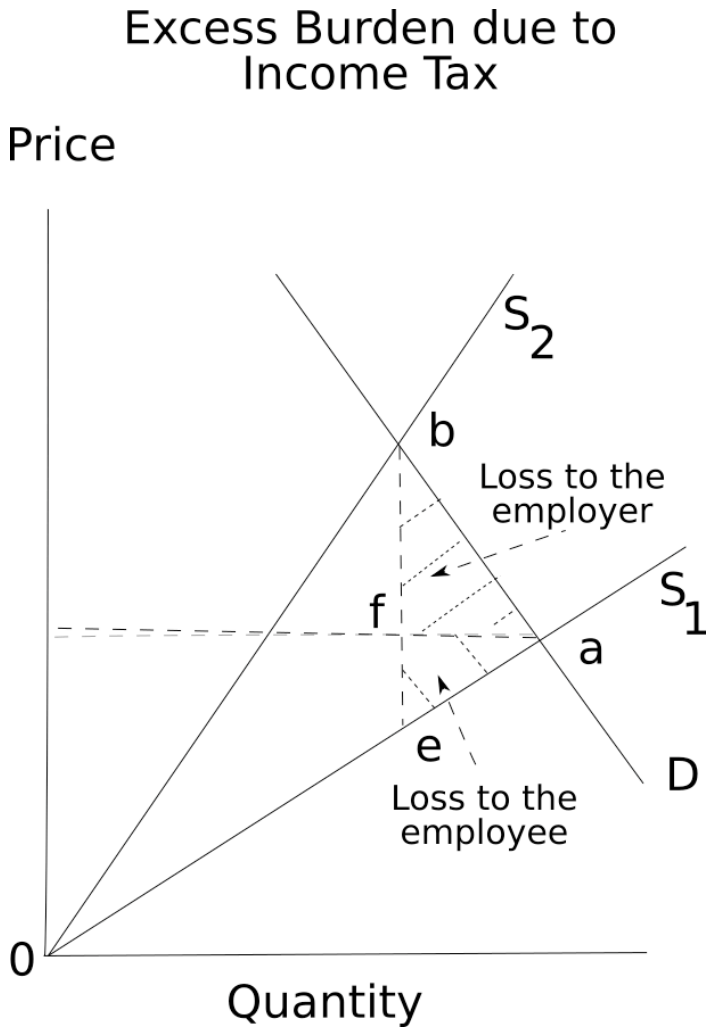


Excess Burden does not drift out into “the economy” as many textbooks imply. A vague loss to the economy. It lands on the transactors, people and businesses. Excess burden, as with incidence is divided between the buyer and the seller. In the above diagram, the

excess burden loss to the seller is the area of the triangle AFE, and the excess burden to the buyer is triangle AFB. Both these triangle vary in size according to the slope (elasticity) of supply and demand. As Demand becomes more inelastic the proportionate loss to the buyer increases, but the total excess burden falls. Similarly, as the supply becomes more inelastic the proportion of the excess burden loss to the seller increases, but the total excess burden declines.

So, both the buyer and the seller are worse off. They lose. Directly. They have less money, much more than the value of the tax. Economic activity shifts along the demand line. The seller sells less, and the buyer buys less.

Excess burden due to income Tax



Excess burden can also occur with income tax. In the above income tax diagram the value of the excess burden is the triangle AEB. The excess burden is divided between the employee and the employer. The excess burden loss to the employee is the triangle AFE, and to the employer ABF.

Again, if the Demand for the employee's services are inelastic, most of the excess burden is borne by the employee. On the other hand if the Supply of employment is inelastic, most of the excess burden is borne by the employee.

The economic activity of the employer is reduced, and the quantity of employment demanded of the employee is reduced. Both are worse off.

Minimising Excess Burden losses

Are there any situations where excess burden losses a minimized, indeed reduced to zero?

We are now going in the direction where this Submission is headed. Yes there are three situations where there are no excess burden effects:

1. Where the supply is perfectly inelastic
2. Where the demand is perfectly elastic and
3. Where economic rents are taxed.

Now, while perfectly inelastic demand and perfectly inelastic supply is not found in real life, near inelastic supply is found. An example of a perfectly inelastic supply is that of land. However more recently it has been found that the supply of land is not quite inelastic[11]. The reason why the empirical measure of the supply of urban property was found to be not quite inelastic was that the supply of the buildings on the land was found to be more elastic. The supply of land and the supply of buildings on them have to be separated.

This will be discussed further in the concept of 'unimproved land values', as tax on unimproved land values is a tax on economic rents, and excess burden is eliminated.

Measuring the Excess Burden

Now these losses are not as I said something theoretical and do not exist. These losses exist and can be **measured.** They depend of course on the elasticities of supply and demand. (This is why I gave a somewhat didactic course in economics in the above section. It is essential to understand the meaning of the elasticities of Supply and Demand, what is Incidence, and what is Excess Burden).

So what are these losses? Have they been measured?

At this point I will say that two types of deadweight losses can be measured, the average deadweight loss, which is the size of the above triangle, and the marginal deadweight loss, which is a measure of the incremental change of the average deadweight loss as the tax value changes.

While economists love the marginal deadweight loss, in order not to confuse the punters I shall stick to average deadweight loss. Suffice to say marginal deadweight losses have been measured as two to three times the average deadweight losses, so there is no respite from this analysis by going in that direction.

[11] Prest, A.R. 1981. "*The Taxation of Urban Land*", Manchester University Press.

A useful summary of the measures of average deadweight losses is in the CIS Report "Cost of Taxation"[12]. Robson provides a couple of useful tables. These are:

Table 2: US Estimates of the Average Deadweight Costs of All Taxes

Study	*Estimate*
Ballard et al (1985)[13]	23.8%
Jorgenson and Yun (1990)[14]	21.2%
Jorgenson and Jun (1991)[15]	18%

This is not an insignificant amount. We are just talking here about the "Economic cost", not the Administrative and Compliance costs previously discussed. All these costs can be substantial. And yes, they massively impact by slowing down the economy and increasing unemployment.

But back to deadweight losses. It is worth quoting Robson "Taxation for all levels of government in Australia in 2003-04 was $257 billion. Applying US estimates of the Average Deadweight Costs to Australia suggests that the total excess burden of taxation in Australia in 2003-04 amounted to at least $46 billion and could be as large as $61 billion. To put this in perspective, in 2003-04 government at all levels spent $51.5 billion on health. Thus the total deadweight loss from taxation in Australia, not including costs associated with administration, compliance and evasion is approximately equal to the amount of public spending devoted to health".

The latest Australian Tax Office figures, for 2013-14, give total taxation revenue for all levels of government as $434 billion. This gives a total excess burden ranging from $78 billion to $87 billion. Total Health spending in 2013-14 was $65 billion.

Or to put it another way, if excess burden is removed, the economy would expand by up to $87 billion. If tax rates remain the same, or total taxes increase pro rata, this will go a long way to cover the expenditure on Health.

[12] Alex Robson 2005 "The Cost of Taxation", *Centre of Independent Studies*, CIS Policy Monograph 68, Page 7.
[13] C. Ballard, J. Shoven and J. Whalley 1985 "*General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States*", American Economic Review 75, pp. 128-138
[14] D. Yorgenson and K. Yun, 1990 "Tax Reform and Economic Growth", *Journal of Political Economy* 98:5, pp. 151-93
[15] D. Yorgenson and K. Yun, 1991 "The Excess Burden of Taxation in the United States", *Journal of Accounting and Finance* 6:4, pp 487-509

The Average Deadweight Cost has also been calculated for income tax. These have been reported by Robson in the following table:

Table 3: US Estimates of the Average Deadweight Cost of Personal Income Taxes

Study	Estimate
Hausman (1981)[16]	18.4% - 22.1%
Ballard et al (1985)[9]	37.4%
Jorgenson and Yun (1990)[10]	33.3%
Jorgenson and Yun (1991)[11]	18%
Feldstein (1999)[17]	32.2%

For those who are interested in the subject there is a good book on the subject, "The Excess Burden of Taxation in the US" by D.W. Jorgenson and KY Yun, 1993. Strangely enough, not much further work has been done in the past 20 years on both the theory and values of deadweight losses. Fashions in these things come and go. Some useful recent theoretical studies are below.[18]

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[16] J. Hausman, 'Labor Supply' in H. Aaron and J. Pechman (eds) 1981 *How Taxes Affect Economic Behaviour* (Washington D.C.: The Brookings Institution

[17] M. Feldstein, 1999 "Tax Avoidance and the Deadweight Loss of the Income Tax", *Review of Economics and Statistics* 81:4, pp. 674-680

[18] L. Creedy 2003 "*The excess burden of taxation and why it (approximately) quadruples when the tax rate doubles*". New Zealand Treasury Working Paper, 03/29 December 2003. Unfortunately the paper includes no measurements.
Followed by J. Creedy 2004 "*The excess burden of taxation*". Australian Economic Review, Vol (37) (4), p454-464. This is an excellent description of the theory of excess burden. To quote a basic conclusion "Hence the excess burden is approximated by one half of the Hicksian Elasticity, multiplied by post-tax expenditure, multiplied by the square of the proportional tax-inclusive rate of tax. That means for example, doubling the rate of tax quadruples the excess burden."
Also J. Creedy, 2009 "*Personal income taxation: from theory to policy*" Australian Economic Review, Vol 42, (4), pp 496-506.
Charles Ballard, Don Fullerton. John Shoven and John Whalley, 1985, "*A General Equilibrium Model for Tax Policy Evaluation*", The University of Chicago Press,Chicago. They say "The deadweight loss increases with the square of the tax rate, and linearly with elasticities".
An interesting theoretical paper. Raj Chetty "*Is taxable income elasticity sufficient to calculate deadweight loss*?", American Economic Review – Public Policy 1(2):31-52, 2009.

Taxing Profits

Strictly speaking the profits companies report do not exist. They are figments of accounts' and business peoples' imaginations. It may surprise the reader that economists, when they are talking about profits, are talking about "pure profits", or economic rents. The concept of profits that are reported and sometimes taxed are a concoction built up by accountants since the nineteenth century of what they think profits should be. The concept has become over time a monstrosity that makes no economic sense at all. In constructing their definition of profits the accountants have been under pressure from two directions, their clients, who wish both to minimize their taxable profits yet maximize their published profits, and governments that wish to maximize taxable profits. This definition has ended up as a mess you can see today, tied up with international agreements that tend to favour the accountants' major clients. There are many examples that can illustrate the nonsense that is the accounting definitions of profits – but there is a major blatant one that can be made an example. When a company's asset values are revised upwards (and occasionally downwards), the increase in asset values are added to (or occasionally deducted from) profits. Why this is so makes no sense to economists. Or governments. The taxable profit in most jurisdictions does not include any form of asset price revisions! This revision of profit levels, and indeed accrual accounting is just flim flam for the general public. Governments, or their tax departments, do not believe it for a moment, and have quite a different definition of taxable profits.

Yet even so, taxable profits understate economic rent values throughout the economy by about thirty per cent. In other words a straight tax on economic rents at the same rate as the current corporate tax rate will increase revenue from this source by at least thirty per cent.

Disincentive effects of current taxation

Will a rent tax hurt business? No, in the sense that taxing economic rents has no adverse effect on business activity at all. It would probably improve it. Why?

It is well known that taxing personal incomes and business reduces activity as taxes rise. In other words the higher the tax the less incentive the corporation or the person has to earn more. But among economists it is also well known that taxing economic rents has absolutely **NO** disincentive effects. At least theoretically, you can increase the economic rent tax to 99% and with absolutely no disincentive effects. As long as a tiny bit of rent remains their incentive to earn more would remain unabated. That 1% economic rent remaining to the taxpayer has exactly the same incentive effect of a 100% economic rent. This may seem strange to non-economists. But economic theory does not relate the effort to achieve an above-normal return to the size of the above normal return. A rent is a rent, regardless of its size.[19]

[19] There is a lot of empirical work on the subject. For instance there is tremendous amount of literature on contest experiments. It has been found that effort remains unabated even when the prize is scaled down.

On top of this, with businesses and corporations, productivity is likely to grow much faster than with the current corporation set up. Why? Because it is well known that the current corporation tax discourages investment. Many theoretical and empirical studies have confirmed this. Thus if increase in productivity are tied up with new capital expenditure, the likely increase in productivity is reduced. Under the present corporation tax, and this is clearly shown in Australia, manufacturing businesses tend to be both under-capitalised and un-productive.

With an economic rent tax, the deduction for capital expenditure is 100%. It is obvious then that businesses would have a strong incentive to reduce their taxes by increasing capital expenditure. This will increase productivity, reduce their costs, and set in motion a beneficial growth cycle. This is something Australia desperately needs. We need to industrialise. We need to become a trading nation. We are an island surrounded by oceans with direct access to the world. We need to take advantage of this asset. Not just a hole in the ground, with a lot a service industries totally dependent on mining.

Would we spend too much on capital expenditure? NO. "It can be shown" that an economic rent tax is "neutral". That means that the amount of capital expenditure will be neither too much nor too little. An ideal "Goldilocks" economic situation. Capital will not be wasted, as in China, or under-invested, as in Australia.

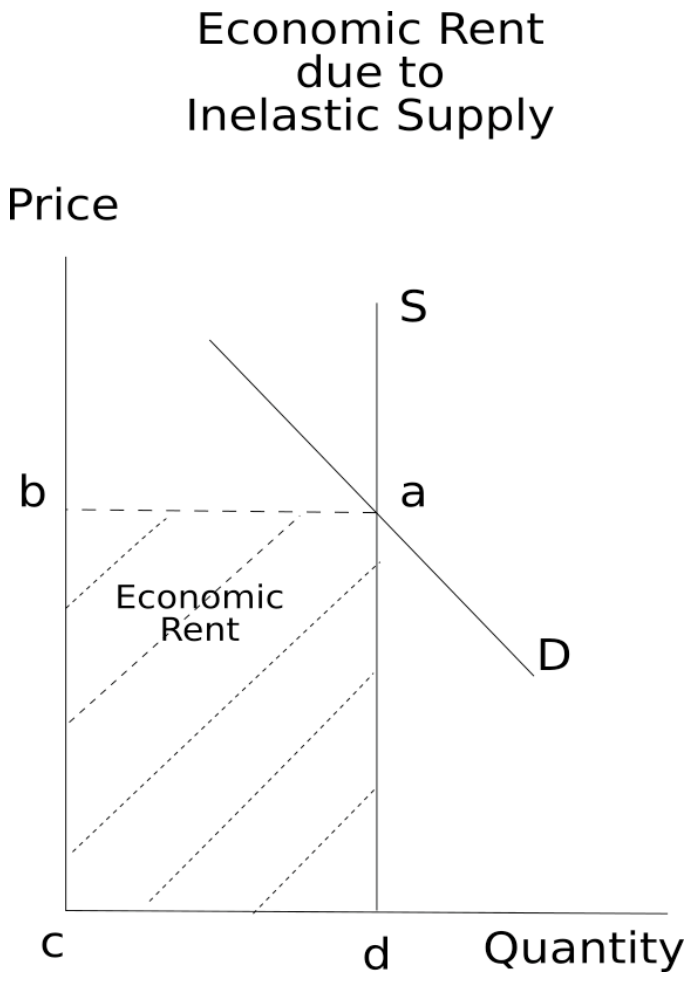
See Shmuel Nitzan 1994 "*Modelling Rent Seeking Contests*". European Journal of Political Economy, Vol 10, Issue 1, May, pp 41-60.
It has been found that oceanic fishers, who pay no tax, maintain the same effort even when fish stocks are depleting, until costs exceed revenue and rents are gone, and then they immediately stop fishing.
See Karl K. Angelson, Steinar Olsen, 1987, "*Impact of fish density and effort level on the catching efficiency of fishing gear,"* Fisheries Research, vol 5, Issue 2-3, July.

Taxing Economic Rents

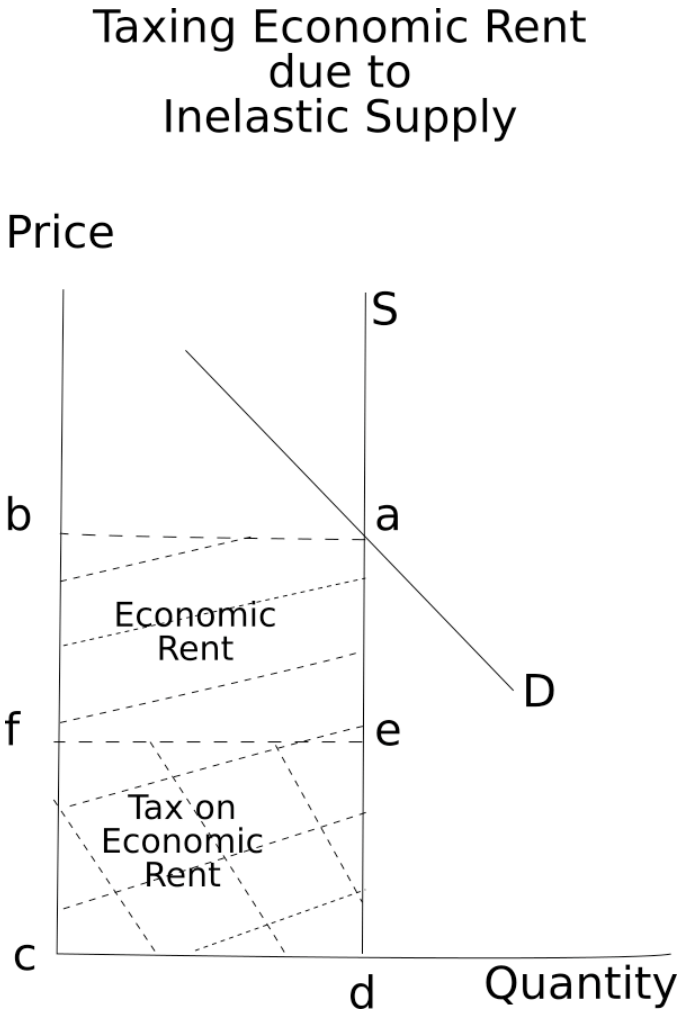
In the following section the benefits of an economic rent tax is discussed for businesses, employment income and the value of unimproved land. It will be shown that this tax is highly efficient, and does not suffer at all from incidence or excess burden. Thus the economy and society will massively gain from both the implementation of economic rent taxes on businesses, employment and the value of unimproved land and also the removal of all other taxes.

What does an economic rent diagram look like?

The most basic diagram for economic rents, going back to the days of Henry George and Ricardo, is a diagram with a vertical Supply line. In this diagram the land supply is inelastic. You cannot increase the supply of land no matter how much you increase the "rent" for land. (Though it has been found that when you start taxing the buildings upon that land, the supply line shifts to a non-vertical position, as you start taxing the supply of capital expenditure on buildings.)



So you have a vertical supply line as in the diagram above. You cannot increase the supply of land. Since you are directly taxing economic rent, you directly extract a chunk of it rectangle to tax, the rectangle DEFC. See below.



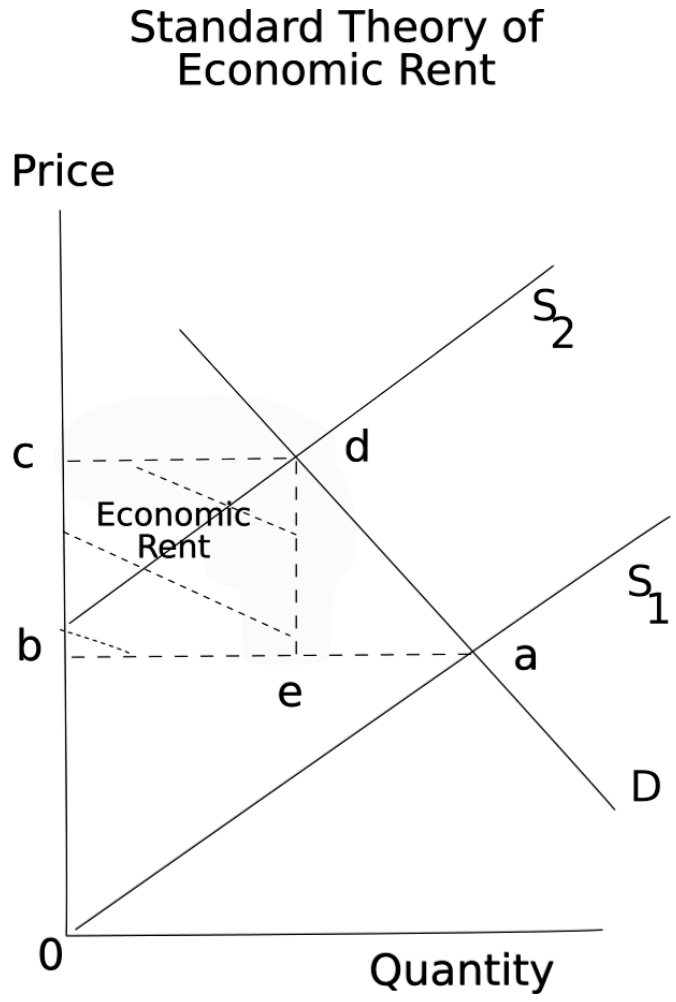
So what is so important about this diagram? It is the culmination of what this submission has been talking about.

1. **The incidence of the tax stays entirely with the supplier.**

2. **There are no excess burden/deadweight losses, (that little triangle), as the supply line is vertical.**

Thus to repeat, with a land tax, which is a tax on economic rents, there are no incidence effects and no excess burden.

So what does a more general economic rent diagram look like (with sloping demand and supply lines)?

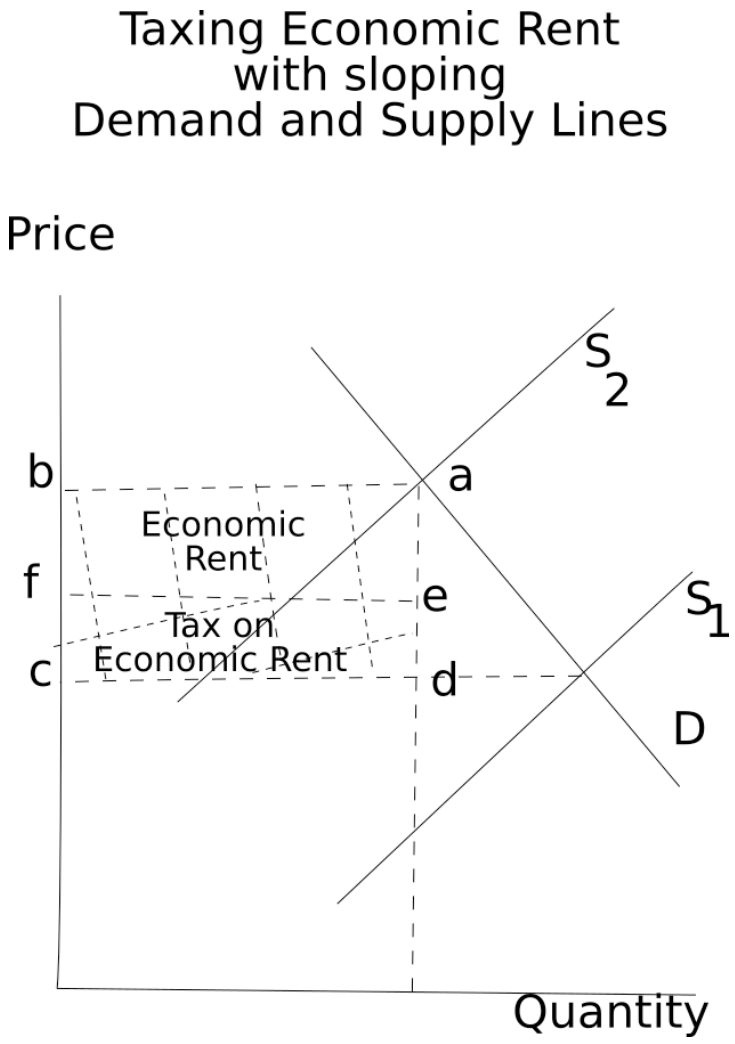


In this diagram, the equilibrium price is B. This is where there are no economic rents. Demand is completely met by supply. This is the equilibrium price, and one might call this the 'basic wage' in the employment market, though this can describe any market.

But supposing in the employment market a powerful trade union manages to raise the wage to C. The increased wage BC is called the 'rental wage', the wage above the basic or equilibrium wage, and the total rent paid is BC times the new number of people employed BE, or the area of the rectangle BEDC.

Or alternatively in a commodity market, a powerful monopolist unilaterally raises the price of goods it sells from B to C and maintains it there. It is the same outcome. Economic rents are created, and they can be taxed.

(As will be described later, economic rents are a permanent element of a free market, as they are maintained by something called ‘market failure’. Old arguments that a market will revert to a zero rent are absolute nonsense.)



Now look at this section of this diagram and compare it to the previous diagram, where a tax is imposed on the economic rent for land, which has the vertical supply line.

When this rent is imposed on a situation with sloping Supply/Demand lines, the new effective vertical Supply line is the vertical line going through A and D to the Quantity axis. We have a direct copy of the situation with land rents.

Thus, as with a tax on economic rents on land, a tax can be imposed directly on the economic rent rectangle CDAB, and the tax is the rectangle CDEF.

Note that, again, the incidence of the tax stays entirely with the seller, and there is no **excess burden with the tax on economic rent.**

It is worth repeating – with a tax on economic rents in any situation, there are no incidence (tax shifting) effects, and there is no excess burden.

That Furphy – Quasi Rents

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The term "Quasi Rent" has been around a long time (especially in bad paperback textbooks). The definition of Quasi Rent is "temporary economic rent". Why temporary? For many years economists have agonized for ideological reasons (Marxist) that long tem economic rents do not exist in a market economy, and if any economic rents exist they are purely temporary and will fall back to zero quickly. For this temporary rent, they coined the term Quasi Rent.

In fact Economic Rents exist long term – and permanently – and they are a major component of a normal functioning market economy. The reason for this is the very high importance of "market failure" in the economy. Market failure is a permanent and major part of a functioning economy. These market failures are the cause of economic rents, the reason why prices do not fall back to competitive equilibrium – ever. In fact modern economists have decided that market failure is so important and fundamental part of the market economy, and a cause and explanation of so many macroeconomic phenomena, that the guys at the University of Chicago are planning to change the structure of their undergraduate Economics course from "Micro and Macro" to "Micro and Market Failure"!

So there is no need to use the name "Quasi Rents". Economic Rents are a permanent and important part of any market economy. And they can be taxed.

The Effect of Excess Burden on the Economy

So far the discussion on Excess Burden has been somewhat theoretical. But this discussion can be clothed finally in a somewhat more practical and dramatic conclusion. Early on, in the section on Measuring the Excess Burden, it was shown that the Average Excess Burden in the United States was around 20%.

In the same section it was remarked that both John Creedy and Charles Ballard found that deadweight losses increase with the square of the tax rate. This tax rate can either be the marginal tax rate of a particular tax if you wish to estimate the deadweight loss of the tax at that point, or if you wish to estimate the deadweight loss for the entire economy, a rough and ready approximation is the average tax rate for the economy. The proportion of tax to GDP.

The proportion of tax to GDP in the US is 26.9%.[20] In Australia this proportion is often given as 28.48%, of total taxation, Federal, State and local, in Australia.

Tax statistics[21] are	million
Commonwealth Government Revenue	$351,522
State Revenue	$68,720
Local Government Revenue	$14,738
Total Revenue	$443,885

Australia's GDP in 2013/14 was $1,5558,334 million

Proportion of Total Revenue to GDP in Australia was 28.48%.

The relation of the Tax Rate to the Deadweight Loss or the Excess Burden can be described in a formula

$E = aT^2$

Where is the percentage of the Excess Burden to GDP and T is the Tax Rate

This is the formula of a parabola with the vertex at position (0,0).

The Excess Burden for the US is about 20% and the Tax revenue to GDP ratio was reported as 26.9%.

Thus $20 = a\ (26.9)^2$

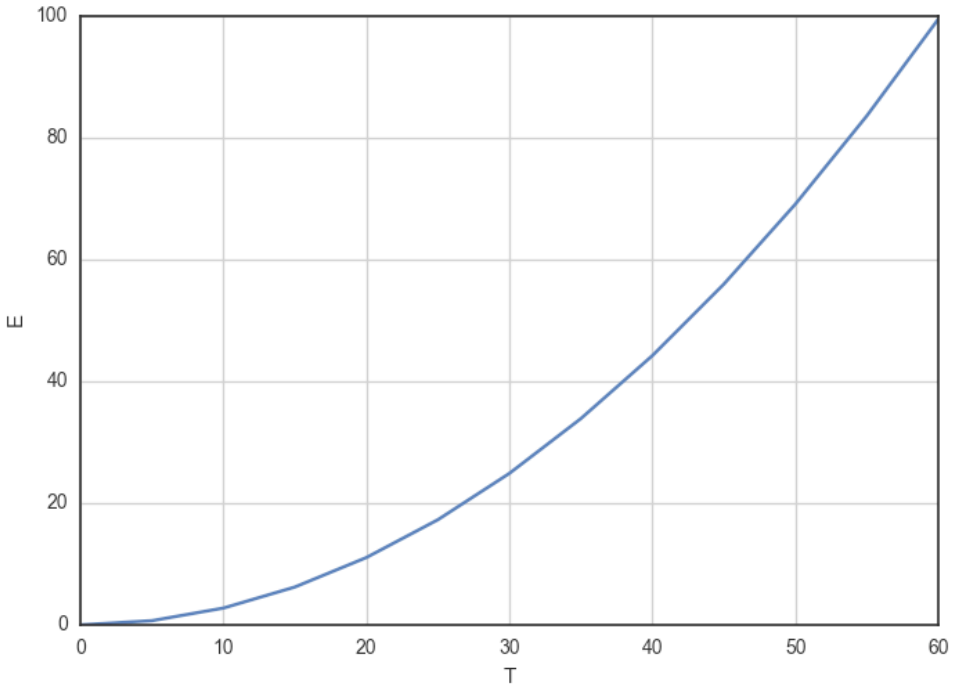
So a = 0.0276392

[20] Wickipedia
[21] ABS 5506, Total Taxation Revenue 2013/14

These values have been calculated in the following table using the above formula and substituting for a.

T %	E %
0	0
5	0.69
10	2.76
15	6.22
20	11.06
25	17.27
30	24.88
35	33.88
40	44.22
45	55.97
50	69.10
55	83.61
60	99.50

Chart of the above table



E is Excess Burden % of GDP
T is Rate of taxation % of GDP

Rate of taxation % of GDP is a proxy for the average tax rate.

While these results are rough and ready they demonstrate two essential points. First, shortly after you go past the present tax to GDP ratio in Australia of around 28%, and Excess Burden of 22%, the Excess Burden accelerates rapidly. We are at the 45^0 tangent of the parabolic curve. The second point is that the "total catastrophe point" is comparatively low. When the proportion of tax reaches 60% the Excess Burden equals 100%! The tax regime takes everything plus. Growth in Australia will fall markedly if the proportion of tax exceeds the present levels as excess burden accelerates. In time of war Britain never managed to increase its rate of tax past about 55%, and had to rely on borrowing.

The rapidly rising Excess Burden of taxation is one of the explanations of the so called 'Laffer Curve', where very rapidly, and at quite low levels of taxation, governments find it more and more difficult to squeeze extra taxation out of the economy.

This result depends of course on retaining our present inefficient tax system with its in-built high and growing excess burden, and not moving to a total Economic Rent Tax regime, where there is no excess burden.

Revenue Estimates

I could have supplied detailed calculations of the potential increase in tax revenue for companies, trusts, partnerships and individual businesses if an Economic Rent Tax was introduced. I have done this estimate, and it works out around at least a 30% increase in revenue.

If people are surprised at this outcome, it should be obvious on reflection. Interest deductions are the major business deduction and are several times the value of capital expenditure. If interest deductions are removed, and even if deductions of the value of capital expenditure are increased to 100%, tax revenue is certain to increase in the short term.

As I said I could have supplied detailed calculations of the increase in the estimated tax revenue for companies, trusts, partnerships and individual businesses if an Economic rent tax is introduced. But after reflection, I have decided not to provide these workings. The reason is that while many people cannot understand economics, they can do arithmetic, and under the advice of Cyril Northcote Parkinson[22], I would be nibbled to death by people contesting tax rates and so on. So I suggest as the arithmetic process is simple, it can be carried out by persons interested in doing so.

How to do it

The latest grouped taxation statistics are the ABS Taxation Statistics 2012-13, which can now be found only on line in spreadsheet form. (A vast reduction in convenience from the previous excellent hard copy publications).

The calculation for the Economic Rent base for each of the separate groups in 2012-13; companies, trusts, partnerships and individual businesses is:

For each group separately

= Total Income for 2012-13 – (Total Expenses for 2012-13 – Total Interest Payments for 2012-13) – Total Capital Expenditure for 2012 -13

The calculation for Capital Expenditure is

= Total Group Assets for 2012-13
- Total Group Assets for 2011-12
+ Group Depreciation 2012-13

[22] C. Northcote Parkinson "The Law", Penguin Books, Harmondsworth, England. In particular I refer to the Chapter "The Law of Triviality" in which the members of a committee quickly vote on a major contract but spend an hour arguing the price of their cups of coffee.

This is repeated for companies, trusts, partnerships and individual businesses. Yes, the ABS separates out the statistics for Individual Businesses.

PAYG employment taxes

PAYG employee income is treated by the ABS separately. The ABS separates out the PAYG incomes into various tranches of income and the tax paid.

It is a requirement of the Economic Rent Tax that the lowest tranches of the PAYG that currently pay tax should be tax-free. I have arbitrarily taken this tax-free tranche to be up to $30,000 per annum, (the upper limit of a lower tranche in the ABS Statistics), and deducted this setoff income from the Total Income to produce a value of the "Economic Rent Income Tax Base".

Then I have assumed the same rate of tax, deductions, etc, for the rest of the income tax. This caused less than a 4% drop in personal tax receipts.

In other words, allowing all income up to the 'basic wage' to be tax-free causes a negligible drop in revenue.

Macroeconomic impact of the Economic Rent Tax

Finally, while these estimates are obviously rough, they are the *minimum* likely increases in revenue. Why? Because an economy that has moved over to an economic rent tax will be vastly more efficient and will grow much faster. There will be higher 'profits' (rents) and much lower unemployment. Remember both the Incidence Effects and Excess burden of taxes will be removed. Removing the Excess Burden will be an immediate shot into the economy of at least 20% of the value of total tax revenue. (See previous estimates).

How this will affect the economy can be estimated using initially a General Equilibrium Model. However GE does not work well with taxes as it is based on constant returns to scale. I would prefer using a Partial Equilibrium model. But to my knowledge there is none in Australia that is working well.

However an Economic Rent Tax will certainly cause increasing growth and increasing revenue almost from day one.

Lump sum taxes and all that

The lump sum tax

To finish, it might be useful to take a quick trip through lump sum tax land. Taxation economics lecturers usually starting with what is considered the most basic possible tax, the lump sum tax, which is a fixed tax which does not vary with anything, and is imposed on the single taxpayer. I won't go into the theory but its incidence stays with the taxpayer.

BUT the lump sum tax is not *directly* a tax on economic rents. It is therefore distortionary.

Some academic may say "Oh, but the lump sum tax may tax economic rents!" But it may not. In fact, if a lump sum tax is imposed on the entire population, it certainly will not.

The Poll Tax

A vertical supply line does NOT always imply a tax on economic rents. A horrible example is the poll tax or head tax. A Poll Tax is not a tax on economic rents, even if the supply line is vertical. This tax (recommended by Richard Musgrave (of Musgrave and Musgrave) to Margaret Thatcher) was the nemesis of Margaret Thatcher and Edward IV. "Can't pay, won't pay". To a non-economist it was obvious that the tax was foolish. But to many (badly trained) economists it was an 'ideal tax' because the supply line was vertical, and had no incidence effects.

BUT a poll tax is NOT a tax on economic rents. Why? Because a fixed tax imposed on a person does not mean that the person has any money at all, much less economic rents, to pay the tax. Furthermore, if that person had any economic rents, the poll tax is not related to the size of the economic rents earned by that person. The tax was bad economics, and as such idiotic.

To clarify, while taxing economic rents eliminates incidence effects and excess burden, eliminating incidence effects and excess burden does not mean you are taxing economic rents.

Land tax

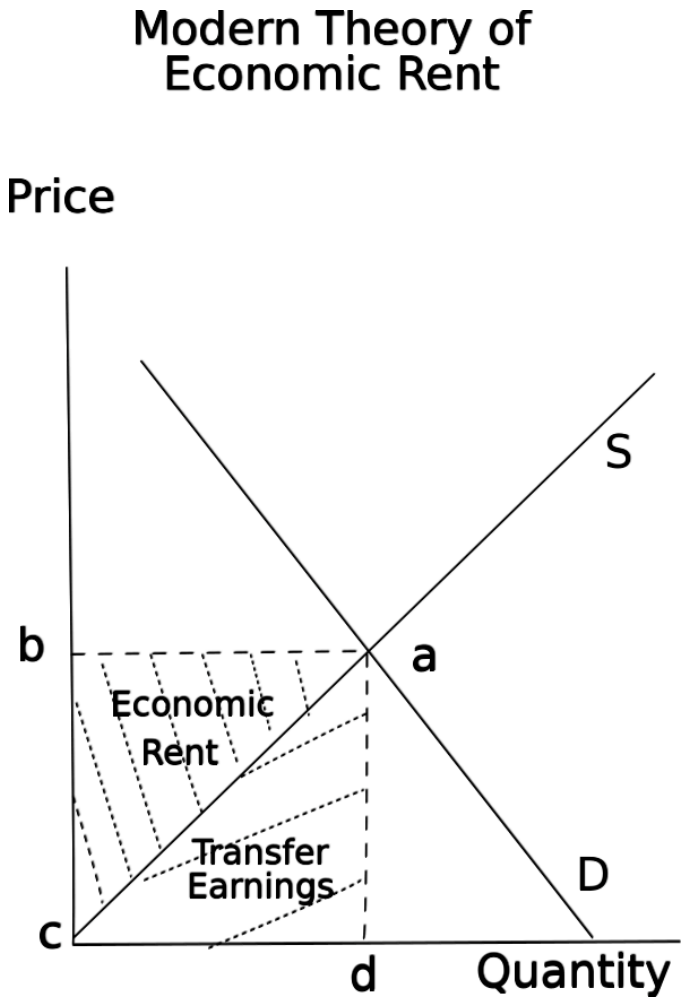
Yes, a straight tax hit on land values could eliminate incidence effects, but that does not mean that you are taxing economic rents. A lot of rural land, and even some urban land, do not have economic rents.

All things with vertical supply lines do not mean economic rents, and the lack of vertical supply lines does not necessarily mean the lack of economic rents. What is needed is a tax on "unimproved land values" – guaranteed to tax economic rents.

A Revisionist Theory – The so-called "Modern Theory of Economic Rent"

Now is the time to wrap up this submission. But it cannot be closed off without mentioning a new theory of economic rents that has taken possession of the economic profession in certain quarters.

In this new theory, it is argued that the total rent paid is the triangle above the Supply line ABC in the diagram below. The triangle below the Supply line is called Transfer Earnings. Rent is calculated as the total cost of wages ABCD less Transfer Earnings ADC. Transfer earnings mean the amount of money any particular unit could earn in the next best alternative use.



The argument goes like this. "Suppose the diagram is an employment market for nurses. Starting at point C and moving towards point A, as the wage rate is raised so more nurses are attracted to the profession. At each higher wage, the *new* nurses attracted are getting

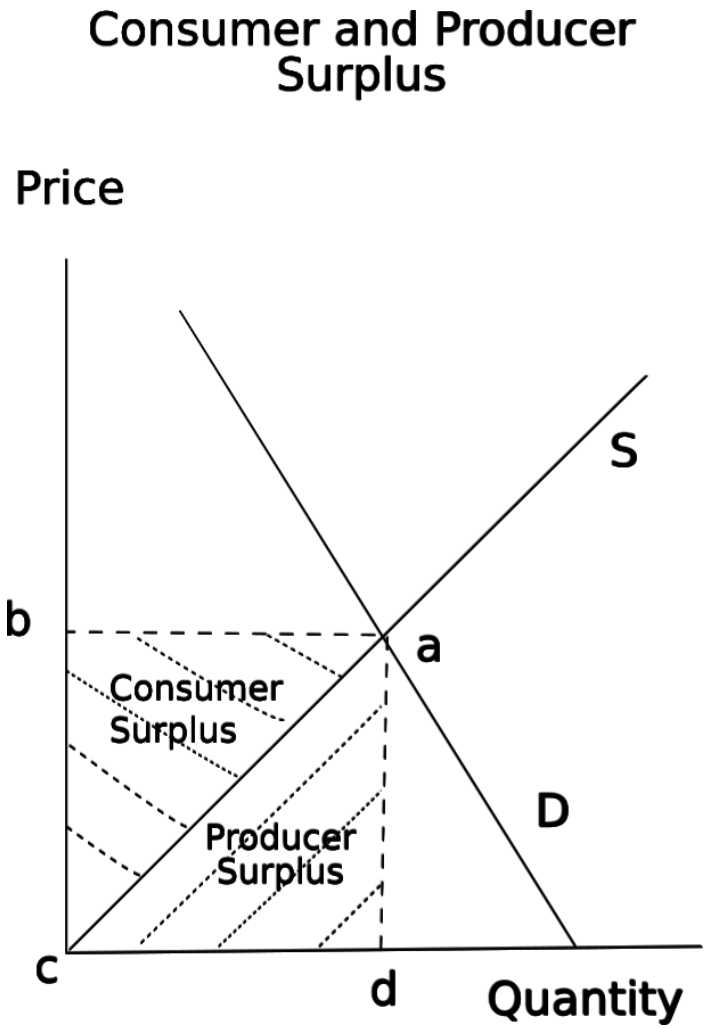
just enough to persuade them to transfer into the profession. The wage for them is entirely transfer earnings. But nurses already in will get economic rent; after all, they are getting more than necessary to keep them in the profession.

Thus at the market wage B, the total economic rent of all employed is shown by the area ABC, the area above the supply curve."[23]

Now the difference between the two theories is not some minor theoretical issue. If for instance you wanted to estimate the total economic rents in the employed work force, you can either 1. With the Modern Theory of Rent, estimate the supply function for all the job categories, and for each job category estimate the size of the triangle ABC; or 2. With the Standard Theory of Rent, you calculate the total value of rents from employment by estimating the 'basic wage', B, then calculate the difference between the basic wage and the wage of everyone with a wage above B, and total them. You would get wildly different answers.

My opinion is that the Modern Theory of Economic Rent is complete nonsense. There are many theoretical objections including the fact that the Modern Theory measure of economic rent coincides with the standard measure of Consumer Surplus and transfer earnings coincide with the standard measure of Producers' Surplus. See the diagram below and compare it with the one above.

[23] Anonymous teacher on Pearson Education
http://wps.pearsoned.com.au/wps/media/objects/1634/1674092/case08_5.htm



Now producers' surplus certainly cannot be called transfer earnings, because that implies that all the gross profits of the producers end up as wages. Similarly consumer surplus is not rents, as a person with a consumer surplus would not necessarily have any rents in their income.

This 'new theory', I feel, falls down from a logical fallacy, arguing from the particular to the general.

Conclusion

A direct tax on economic rents is the only possible non-distortionary tax. It has the advantages of:

1. Business tax revenue will increase by at least 30% immediately, and revenue growth will be much faster than under the present tax system as the economy is vastly more efficient. Income tax revenue will not be much reduced immediately, and will increase much faster than under the present tax system.
2. Businesses will invest more compared to the present business tax due to the 100% deduction, and as investments carry with them productivity gains, business will become more productive, making the economy more productive, ultimately increasing employment!
3. The Economic Rent Tax has no Excess Burden. This is a major gain to the economy. This gain can be used to rapidly expand the economy, reducing unemployment.
4. The Economic Rent Tax has no Incidence Effects, or tax shifting in harmful ways. The tax stays with the taxpayer. Under the present tax system much of the tax is shifted to the economically weak.
5. Following the two above, Economic Rent taxes are completely non-distortionary. There are no adverse and costly effects imposed on the economy and individual taxpayers.
6. As a consequence of the higher rate of investment and a non-distortionary tax system, economic growth will be much faster, reducing unemployment.
7. Compliance and collection costs will be far less. The present tax systems are horribly complicated with vast tax laws. Economic rent taxes are far simpler. Furthermore, the arbitrary and nonsensical definitions of profits currently used cause many revenue losses and distortions.
8. I hate to say this, but the rate of taxes can be increased using the Economic Rent Tax without reducing the incentive to work.

If economic rent taxes are imposed, ALL present taxes must be removed. The gain in revenue by imposing a separate tax is small because of the already discussed incidence effects and major efficiency losses will be caused. If more tax is required, it is far better to raise the economic rent tax. Maybe there is a case for taxes aimed at directly reducing consumption, such as on petrol and cigarettes. But the efficiency losses must always be estimated.

Post Script

A number of nonsensical tax proposals continue to float around – wealth taxes, consumption taxes, expenditure taxes, transaction taxes…If you question the promoters of these taxes about the incidence and excess burden effects you get a stunned goldfish look, and a mumble that "It is not important".

The proposed transaction tax is particularly virulent, because any, even small, increases in transaction costs gum up the works and cause a major increase in market failure (that major interest of modern economists). Increased market failure will cause adverse and unintended consequences (a transaction tax on bank transactions will for instance cause a major increase in currency holdings), but it will cause a significant fall in growth (market failure does that) and a rise in unemployment.