RETHINKING the TAXATION of CORPORATIONS

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Statement of Authentication

The work presented in this thesis is, to the best of my knowledge and belief, original except as acknowledged in the text. I hereby declare that I have not submitted this material, either in full or part, for a degree at this or any other institution.

Elfriede Sangkuhl
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List of Abbreviations

AIFRS ........................Australian equivalents to International Financial Reporting Standards
ASEAN .................................................................Association of Southeast Asian Nations
ASX .................................................................Australian Stock Exchange
ATO .................................................................Australian Taxation Office
Austrade .........................................................Australian Trade Commission
BHP ..............................................................................................BHP Billiton
CCPC ..............................................................Canadian Controlled Private Corporations
CCCTB ...........................................................Common Consolidated Corporate Tax Base
Cth ......................................................................................Commonwealth
CTT ..............................................................................................Currency Transactions Tax
CTTO ..............................................................Currency Transactions Tax Organisation
DCITA ..........Department of Communications, Information Technology and the Arts
DPP ..............................................................Commonwealth Director of Public Prosecutions
DTA ..............................................................Double tax agreement
EU ..............................................................................................European Union
IAS .................................................................International Accounting Standard
IASB ..............................................................International Accounting Standards Board
IFRS ..............................................................International Financial Reporting Standards
ICT ..................................................................................................Information and communication technology
IOSC ..............................................................International Organization of Securities Commissions
ITAA .................................................................Income Tax Assessment Act (Cth)
ITAA36 .................................................................Income Tax Assessment Act (Cth) 1936
ITAA97 .................................................................Income Tax Assessment Act (Cth) 1997
ITE ..............................................................................................Income tax expense
GST ..............................................................................................Goods and Services Tax
MNE ..............................................................................................Multinational Enterprise
NATO .................................................................North Atlantic Treaty Organization
NPBT .................................................................Net profit before tax
NSW ..............................................................................................New South Wales
OECD .................................................................Organisation for Economic Co-operation and Development
OTML ..............................................................................................Ok Tedi Mining Limited
R&D ..............................................................................................Research and Development
SME ..............................................................................................Small to medium enterprises
TNC ..............................................................................................Transnational Corporation
TR ..............................................................................................Taxation Ruling
UDITPA .................................................................Uniform Division of Income for Tax Purposes Act (US)
UK ..............................................................................................United Kingdom
UN ..............................................................................................United Nations
UNHCR .................................................................United Nations High Commissioner for Refugees
US .................................................................United States of America
VAT ..............................................................................................Value Added Tax
WSS ..............................................................................................Wage Subsidy Scheme
WTO ..............................................................................................World Trade Organisation
Abstract

This thesis examines the taxation of corporate profits in Australia. The thesis is primarily about equity: equity between corporations, legally constructed persons, and human beings.

The classical liberal and neo-liberal approaches to human rights are compared with the social liberal approach to human rights and taxation is regarded as a human rights issue.

The thesis examines the advantageous treatment that corporations receive, as opposed to humans, in taxation rates and in receiving government welfare payments by way of corporate welfare. Corporations are, unlike humans, able to take advantage of transfer pricing giving taxation jurisdictional flexibility.

The thesis examines how much tax Australian companies actually pay and the importance of company tax revenues as a proportion of total taxation revenues. This demonstrates the revenue imperative for taxing jurisdictions to effectively tax company profits.

The thesis looks at how companies are taxed in the jurisdictions of the United States of America and Canada because they both tax companies at state/province level and at a federal level. That is, they deal with allocating company profits and therefore taxation over different taxing jurisdictions. The thesis surveys and critically analyses various company taxing alternatives being discussed in the European Union.

The thesis develops and explores concrete alternative taxing proposals for corporations. The proposals aim to fairly secure tax revenues from corporations and their shareholders, decrease the opportunities for tax avoidance and allocate corporate tax between taxing jurisdictions.
Chapter Outline

1. The classical liberal and neo-liberal approaches to human rights are compared with the social liberal approach to human rights and taxation is regarded as a human rights issue.

2. The current neoliberal, classical liberal and social liberal positions with respect to taxation are examined.

3. The neoclassical economic and social liberal views of the capital, profits and the firm are examined.

4. The history of companies is considered, especially the advantages of limited liability to companies and their shareholders.

5. Corporate welfare is examined: the conditions applied to, the transparency of, and the amount of welfare received by, corporations is compared to welfare granted to persons.

6. The special ability of corporations to engage in tax avoidance and tax planning using transfer pricing is examined.

7. How much tax Australia’s companies actually pay is examined and especially how much tax is paid by Australian’s largest corporations.

8. How companies are taxed in other federal jurisdictions similar to Australia is examined, that is, the US and Canada. The progress of corporate tax harmonisation in the European Union is also examined.

9. The thesis concludes that the taxation of corporations needs to be reassessed and that companies should be taxed using
   - the ‘classical’ taxation of company profits recognising their separate personhood,
   - corporate welfare provided by state and federal governments should be abolished, and
   - worldwide profits of corporate groups should be taxed using the ‘formula’ method to apportion taxes between jurisdictions.
Thesis Introduction

This thesis presents a systematic historical, legal, economic and political theoretical study on the taxation of Australian companies in the context of tax avoidance by companies using transfer pricing and globalisation. The thesis also includes elements of a comparative study. Australian company taxation rules and principles are assessed in light of Canadian, United States and European Union systems.

The research problem addressed by this thesis is finding ways to fairly tax the profits of corporations. Finding ways so as to do justice is complex and difficult. Add in the fact that most major corporations earn profits globally; trying to fairly allocate those profits and the associated tax liabilities globally are even more difficult. John Stuart Mill who, while recognising the difficulty of ‘doing perfect justice in taxation’ held that “the difficulty of doing perfect justice is no reason against doing as much as we can.”

The conclusions of the thesis are normative policy recommendations:

(i) The ‘classical taxation of company profits, that is, abolishing dividend imputation,

(ii) The abolition of corporate welfare and

(iii) The taxation of the worldwide profits of corporations by using the formula method to apportion taxes between jurisdictions.

The thesis constructs a practical argument. The argument is not based on the use of specific research methods rather the approach is empirical and descriptive with elements of a comparative study examining company tax in the the jurisdictions of Canada, the United States and the European Union.

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Chapter 1 Taxation as a Human Rights Issue

Introduction

In this chapter the classical liberal and neo-liberal approaches to human rights are compared with the social liberal and communist approach to human rights. The two broadly different approaches require different levels of government funding in order to fund human rights. The dominant views of human rights prevailing in a society make acceptable and shape the taxation policies of that society which is why it is important to understand these views.

In Australia, as in most of the world, the material conditions of production are held in private hands and the distribution of the means of production is by means of monetary exchange. Taxes are, therefore, required to provide the economic basis of the machinery of state; to provide public goods and to act as some measure of redistributing wealth to redress material inequalities in pursuit of a society where the provision of positive human rights still has value.

Efficiency in Taxation

Recent taxation literature almost always includes the factor of ‘efficiency’ when talking about tax systems. The most common, uncontroversial analysis of a ‘good’ taxation system usually uses utilitarian measures of economic efficiency. For example, “(a) good tax system would promote equity, be cheap to administer, easy to understand and not lead to a gross distortion of resources.”\(^2\) Australian taxation texts and articles about taxes commonly commence with such an uncritical restatement of utilitarian efficiency. The Australian tax system has been the subject of many parliamentary reviews and their terms of reference also contain similar words. The latest comprehensive review of business taxation, undertaken in 1999, also used this language as do most analyses of taxation system. For example, the terms of reference for that review required that the recommendations of the review be consistent with the aims of improving the efficiency of Australian business, providing a secure source of revenue, enhancing the stability of taxation arrangements, improving simplicity and transparency and reducing the costs of

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compliance. The Review will adopt a comprehensive approach to reform driven by clear, sound principles involving a move towards greater commercial reality.\(^3\)

Even though the title of the Review included the words, “more certain, equitable and durable”\(^4\), the actual terms of reference did not consider equity at all.

The sort of efficiency considered in the analysis of most taxation policy is grounded in neoclassical economic theory, this will be further considered in chapter 3. And this type of efficiency is a restricted view of efficiency because it gives rise to the following views of corporate taxation;

**Common Views about Corporate Taxation**

1. The direct taxation of corporate profits should be kept to a minimum because that will  
   a. Encourage corporate growth and investment and create jobs and prosperity, and  
   b. Stop companies fleeing abroad chasing lower taxes.  
2. The taxation of dividends in the hands of shareholders should be minimised through the use of dividend imputation because  
   a. This is merely avoiding double taxation, and  
   b. This will encourage investment in shares, which encourages corporate growth and which is good for society.  
3. Companies should be taxed because  
   a. Companies benefit from government spending, and  
   b. Companies should contribute to government revenues used to provide corporate welfare.

**Issues Raised by these Views**

These commonly held views are contradictory. They are divided between the perceived good of minimising corporate taxes while at the same time recognising the need to levy taxes. Underlying these views are a number of assumptions which raise questions, such as  

1. Do lower company taxes encourage investment?  
2. Will highly taxed companies flee abroad?  
3. Does increased share purchase sustain increased corporate growth?  
4. Is corporate growth a good thing?  
5. Is the taxation of share income double taxation?

\(^4\) Ibid, title page
6. What is equity in taxation?

This thesis will discuss these issues and question the underlying ideas on which these common views are based, while focussing on taxation as a matter of equity.

**Equity in Taxation**

Classical and neoclassical analyses of efficiency conspicuously fail to consider or take seriously the issues of equity in assessing taxation systems.

Equity is a fundamental ethical value. Equity is taken for granted in retributive justice and the law, especially the criminal law. Formal equality before the law, for example, is taken for granted as a tenet of a just society. This thesis argues that distributional justice, that is, equity in relation to the distribution of wealth, income and the benefits of society, should also be a fundamental value.

Aristotle equates happiness, in the words of Braques, as “activity that makes appropriate use of our capacities, a way of life in which we are optimally functioning in accord with our purpose as human beings”\(^5\) our purpose being the good or virtuous life. Aristotle recognises that “human beings are social and political animals”\(^6\) therefore the good life must be furthered within the social context. Government policies, especially taxation policy, should therefore also be assessed in terms of distributional justice.

If justice is the equal protection of the rights of all human beings as it is in the provision of equality before the law, formal justice, so should it be applied in providing distributional justice.

**Rights**

Rights can be defined as legitimate entitlements of individuals or groups to access to, or effective control of, particular goods or services or the free exercise of particular abilities or powers. Nickel expresses rights thus; “rights have rights-holders (as) parties that possess and exercise the rights (and) a right is to some freedom, power, immunity, protection or benefit, which is its scope or object.”\(^7\)

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\(^6\) Ibid

Rights imply responsibilities or obligations. The responsibilities are that the rights holders exercise their rights in an appropriate fashion by not infringing on the rights of others. The obligations are that others respect and, in certain circumstances, facilitate the effective realisation of the rights in question.

The process by which rights, or legitimate entitlements, gain legitimation depends on the type of right in question. Legal positivists understand legitimation in terms of the actions of legitimate authority in endorsing and enforcing such rights. Here, we can distinguish ‘acquired’ rights from rights that human beings possess by virtue of their common humanity. Rights can be acquired or created through the exercise of some sort of social power, authority, agreement or decision-making.

In Roman times “individuals had rights and corresponding duties in consequence of the laws under which they lived.” In Medieval times, law defined the inherited rights and privileges of the ruling class of Lords and Church officials, as rights of control over the working population of peasant serfs. The English revolution of the seventeenth century was the first of the great social revolutions that overthrew royal absolutism and ultimately shifted political power to parliamentary bodies with limited representation. This revolution shifted the concept of rights beyond institutional legal support for the interests of particular social groups to embrace the entire political community. The revolutionaries developed the idea of universal human rights to articulate their demands for change. Rights were, from then on, seen to be possessed by all individuals simply because of their common humanity. This moral status of human rights then imposed duties in respect of such rights upon all people.

The English revolution and subsequent revolutionary challenges to the feudal hierarchy were prompted by the development of new political and social thought. The most significant of these for contemporary western politics was the tradition of classical liberalism developed through the work of Thomas Hobbes, John Locke and Adam Smith.

**Classic Liberalism**

Western European society and ideology was dominated by the Catholic Church until the reformation of the sixteenth century. The “outlook of most men, including the majority of philosophers … (was) controlled by a social institution, namely the Catholic Church: what

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9 Ibid
was true and what was good was to be ascertained, not by solitary thought, but by the collective wisdom of the councils”\textsuperscript{11} interpreting the will of God. “The first important breach in this system was made by Protestantism, which asserted that General Councils may err. To determine the truth thus became no longer a social but an individual enterprise.”\textsuperscript{12} These challenges to the absolutism of the church in Rome and to the monarchy led to a revolution in philosophical thought.

Ideas of human rights amongst the classical liberal thinkers of the seventeenth and eighteenth century are very closely bound up with their particular ideas about the relations between human individuals on one side and social structures and relations on the other. Classical liberals tended to be what are today called ‘methodological individualists’. Social structures and social relations are seen as the effects, products, creations, intended and unintended consequences of the intentional action and interaction of human individuals. Actions are seen as being driven by individual psychological instincts or tendencies that predate social structure and are common to all human beings. This ‘human nature’ has profound influence on classical liberal thinking about the creation and explanation of social structures, processes and developments which are seen as the product of human decisions, co-operation and conflict.

The classical liberal tradition is centred upon the belief that people act in the pursuit of individual self interest. The classical liberal premise is that all human beings, if not under the control of some central power, are by nature selfish, lazy and greedy. Human beings seek to satisfy their desires through the appropriation of relevant goods and services. If unfettered, humans are intrinsically competitive, power-seeking and domineering. On the positive side humans can also be creative, dynamic and productive. Humans engage in continual calculation of the balance of cost and benefit to themselves of the different options available to them and pursue the action optimally beneficial to them. Humans are strongly motivated to barter, trade and accumulate wealth and they respond badly when they are not permitted to engage in these activities.

This thinking strongly reflected the aspirations of the new capitalist middle class of merchants and manufacturers in their struggle against feudal absolutism. Classical liberal theory emphasises the idea of the positive potential of individuals if the individuals are unrestrained and unfettered from unnecessary limits and distortions imposed by state power

\textsuperscript{12} Ibid
and the established hierarchy. This ‘freeing’ of the individual allows for individual fulfilment and social progress. Therefore individuals should be free to do what they want as long as they do not impinge upon the freedom of others to do the same.\(^{13}\)

This central focus on freeing the individual from state power reflects an emphasis on what are called process rights: rights to a fair trial, freedom from arbitrary arrest, torture and cruel punishment. The other dimension to classical liberalism is the centrality of free markets and the capitalist pursuit of profits in these free markets.

For classical liberals the free market is seen as conducive to harnessing individual selfishness, idleness and greed and converting them into the driving forces of creativity, effort and innovation which will serve the common good of effective wealth creation and distribution.\(^{14}\)

Therefore classical liberals view market relations as ‘natural’. The requirements for ongoing market relations are respect for life and property and these are thus also seen as being the ‘natural’ right of all humans. Markets require constructive effort in the production and distribution of goods and are always under threat by human self-interest and the competition for scarce resources. This threat to the operation of free markets motivates rationally self-interested individuals to contract together to grant coercive power to a sovereign or the state to formulate and enforce laws such as right to life and property.\(^{15}\)

The possibility of coercive sanctions for breaking the law shifts individual cost-benefit analysis away from robbery and murder towards respect for life and property and constructive effort. Authority only retains its legitimacy by effectively safeguarding the human rights to life and property through the effective exercise of a monopoly of armed force. To this end it is legitimate for the state to levy taxes on its citizens to finance this protection. Beyond this point classical liberals were generally hostile to further state interference in individual decision making or further financial imposts, believing that the individual should be free from any further state control, regulation or restriction. Citizens also retain the political right to remove or replace the sovereign or the state if the sovereign or the state fails to protect life or property or tries to impose further restrictions on individuals.\(^{16}\)

\(^{13}\) Mann S, Unpublished work in progress

\(^{14}\) Ibid

\(^{15}\) Ibid

\(^{16}\) Ibid
The founder of philosophical liberalism was John Locke (1632-1704). According to Locke, the protection of property is the main reason men submit to government. Bertrand Russell, quoting Locke:

The great and chief end of men uniting into commonwealths, and putting themselves under government, is the preservation of their property; to which in the state of nature there are many things wanting.

The main ‘thing wanting’ under a state of nature is law, and the main function of law is to protect people from injury to their person and their property. This utilitarian position in its absolute form, is incompatible with “the doctrine that an individual has certain inalienable rights” because Locke’s emphasis on the supremacy of property rights would seem to be incompatible with taxation. Taxation could be seen by some as forcible confiscation of property. However, Locke saw taxation as legitimate activity of government, saying that “the expense of government … must be borne by the citizens, but with their consent.”

Taxation therefore should be raised only with the consent of the citizenry and, by implication, only to defend life and property.

Adam Smith clarified the idea of individual self-interest driving market relations which deliver social utility. This utility is limited to productive efficiency and to increasing low cost consumption.

Adam Smith, arguably, the founder of modern market economics and an adherent of classical liberalism “was the first thinker to envisage a complete market society wherein all ‘factors of production’ (labour, land and capital) could be bought and sold in the market place”. Smith believed that the value of a product would be determined by “the social mechanisms that determined the average levels of wages, rents and profits. Thus Smith could argue that the growth of industry and of the total national product, the wealth of the nation, would be in the interests of all; landlords, capitalists and workers alike.”

Human beings should therefore be free to engage in market relations in the pursuit of profits which will be of benefit to the entire nation. In his Wealth of Nations Smith coined the expression the

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17 Russell B, History of Western Philosophy, as above, p584
18 Ibid, p604
19 Ibid, p606
20 Ibid, p609, Russell quoting Locke
22 Ibid, p5
‘invisible hand,’ meaning the invisible hand of the market which made utilitarian, economically rational decisions that would benefit society.

But the annual revenue of every society is always precisely equal to the exchangeable value of the whole annual produce of its industry, or rather is precisely the same thing with that exchangeable value. As every individual, therefore, endeavours as much as he can both to employ his capital in the support of domestic industry, and so to direct that industry that its produce may be of greatest value; every individual necessarily labours to render the annual revenue of a society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good. It is an affectation, indeed, not very common among merchants, and very few words need be employed in dissuading them from it.²⁴

In other words, human beings should be free from state power in order to allow for individual fulfilment and social progress. This minimalist view of rights, limited to negative rights to be free from interference, leads to a minimalist view of taxation.

**Classical Liberalism and Justice**

The classical liberal view of both legal and economic justice centres upon ideas of just deserts. Individuals should, and generally do, reap the benefits or suffer the consequences of their own free choices and actions.²⁵

In the economic sphere, this free choice produces inequality of outcomes with some individuals acquiring more material rewards as they work better, harder and/or longer than others. This resulting inequality is considered to be a good thing because it is seen as providing necessary incentives to productive effort, initiative, innovation and the best use of

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²⁵ Mann S, *Unpublished work in progress*
available resources to maximise efficiency and output. Inequalities are also seen as fuelling aspirations for more consumer goods which fuels economic growth. Classical liberals see substantial gains as necessary to reward effort and talent and to ensure that talented people are motivated to make the best use of their talents and to assume authority in society. Poverty and privation are considered necessary to induce individuals who are lazy and slothful to make use of their talents.

Free market forces, left to themselves and without government intervention, are thought to provide precisely the positive and negative incentives necessary to ensuring optimum social contribution and social production. Market forces are seen to ensure that individuals are rewarded in direct proportion to the value of their real productive social contribution, or punished through lack of rewards if they fail to contribute\textsuperscript{26}.

According to classical liberal psychology as a result of selfish human nature an individuals’ first moral responsibility is to themselves; to take charge of their own life and make the best of it without any legitimate expectation of help or support from others. Nor do individuals have any responsibility to look after or support others, although they may freely choose to do so\textsuperscript{27}.

As the free market requires a degree of effort and sacrifice in order to earn legitimate rewards, some selfish individuals will inevitably choose to ignore basic property rights in pursuit of their own gratification. The threat of effective punishment is necessary to deter these potential malefactors. Serious infringements of others’ basic rights to life and property require equally serious responses from the forces of law and order. This requires negative consequences for malefactors in order to deter them from future malfeasance and to deter other potential malefactors\textsuperscript{28}.

In reaction to the arbitrary and hierarchical justice system of feudal society with one law for lords and another law for merchants and peasants, classical liberals demanded formal or procedural equality in formulation and application of the law. All people should be subject to the same laws and all should expect to be treated in the same way by the legal system, with punishment fitting the crime rather than the perpetrator\textsuperscript{29}.

\textsuperscript{26} Mann S, \textit{Unpublished work in progress}
\textsuperscript{27} Ibid
\textsuperscript{28} Ibid
\textsuperscript{29} Ibid
Classical liberalism therefore, in respect of distributive and retributive justice was based on an underlying principle of equality and proportionality of deserts. An individual can legitimately expect reward in direct proportion to their social contribution of value creation and punishment in direct proportion to the extent of harm they have inflicted.

**John Stuart Mill**

John Stuart Mill’s ideas combined a traditional liberal individualism and faith in the power of the market recognising the need for significant state intervention to protect political rights and promote the free development of individuals. Mill was increasingly critical of what he came to see as radical inequality supported by free market relations, with the excessive wealth of the minority obstructing the liberty of the less well off majority. Mill advocated heavy inheritance taxes, guaranteed basic income and state facilitated education for all.

In his work *On Liberty*, Mill explores “the nature and limits of the power which can be legitimately exercised by society over the individual.”\(^{30}\) In this essay, Mill defines human rights thus:

> The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number is self protection. That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant.\(^{31}\)

This is a classical liberal position. Contemporary liberal right-wing conservatives, also called neoliberals, use this quote from Mill as well as Smith’s idea of the ‘invisible hand’ to support their idea that freedom means freedom from government to transact in the market place and that the only interference acceptable by government is to ‘prevent harm’ to its citizens. Harm is limited to physical harm and infringement of property rights.

Contemporary conservatives frame their beliefs in the language of economic efficiency and utility. Mill also frames his beliefs in utilitarian terms, however he recognises a much broader utility than envisioned by the neoliberals. Mill states:


\(^{31}\) Ibid, pp51-52
I regard utility as the ultimate appeal on all ethical questions; but it must be utility in the largest sense, grounded on the permanent interests of man as a progressive being.\textsuperscript{32}

Mill believes that men do not enjoy human rights unless they are free in the broadest sense. For Mill this broad sense “the appropriate region of human liberty”\textsuperscript{33} comprises

First, the inward domain of consciousness; demanding liberty of conscience in the most comprehensive sense; liberty of thought and feeling; absolute freedom of opinion and sentiment on all subjects, practical or speculative, scientific, moral or theological.\textsuperscript{34}

Mill here is talking about freedom of thought and expression, neither of which can be properly exercised without education. In his \textit{Principles of Political Economy}\textsuperscript{35}, Mill proposes “effective national education”\textsuperscript{36} as a means of eradicating poverty. Mill stated “that the aim of all intellectual training for the mass of the people, should be to cultivate common sense; to qualify them for forming a sound practical judgment of the circumstances by which they are surrounded.”\textsuperscript{37} Even though Mill did not necessarily see the state as the optimum provider of education he saw the state as making possible and providing the conditions for the education of all children. The human right to education is a positive right that needs to be provided by the state.

Secondly, the principle requires liberty of tastes and pursuits; of framing the plan of our life to suit our own character; of doing as we like, subject to such consequences as may follow: without the impediment of our fellow-creatures, so long as what we do does not harm them, even though they should think our conduct foolish, perverse or wrong.\textsuperscript{38}

On the liberty to work, Mill is saying men need suitable and satisfying employment and freedom of opinion.

\textsuperscript{32} Ibid, p53
\textsuperscript{33} Ibid, p54
\textsuperscript{34} Ibid
\textsuperscript{36} Ibid, p366
\textsuperscript{37} Ibid
\textsuperscript{38} Mill JS, \textit{On Liberty}, as above, pp54-55
Thirdly, from this liberty of each individual, follows the liberty, within the same limits, of combination among individuals; freedom to unite, for any purpose not involving harm to others; the persons combining being supposed to be of full age, and not forced or deceived.  

This is freedom of association whether it is political parties or trade unions, and companies and corporations. These political rights are the foundation of democracy.

At first glance these appear to be freedoms from government interference and therefore reflect human rights as negative, or first generation human rights as espoused by classical liberals and neoliberals. Mill however conceives his broad range of human rights as both negative and positive.

Every one who receives the protection of society owes a return for the benefit, and the fact of living in society renders it indispensable that each should be bound to observe a certain line of conduct towards the rest. This conduct consists first, in not injuring the interests of one another; or rather certain interests, which, either by express legal provision or by tacit understanding, ought to be considered as rights; and secondly, in each person bearing his share (to be fixed on some equitable principle) of the labours and sacrifices incurred for defending the society or its members from injury and molestation. These conditions society is justified in enforcing at all costs to those who endeavour to withhold fulfilment.

Mill explicitly requires education to be provided to all members of society, because he recognised that without education a person can’t make choices or be ‘free’. In The Principles of Political Economy, Mill fleshes out his broad sense of human rights by requiring that income below the ‘necessaries of life’ to be tax free: for the imposition of inheritance taxes, progressive income taxes and land taxes. Peter Self avers “John Stuart Mill stood at the liberal crossroads”. While Mill “believed in the truth of market principles,.…. he also anticipated the ‘positive liberals’ in his later quest for setting political and moral limits to their operation.”

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39 Ibid, p55  
40 Ibid, p122  
41 Self P, Rolling Back the Market: Economic Dogma and Political Choice, as above, p37  
42 Ibid
The freedoms espoused by Mill are positive or second generation rights. These rights as well as negative and first generation rights are reflected in the Universal Declaration of Human Rights.

Mill is given prominence because his views are used by neoliberals and social liberals. The economic views of JS Mill and especially his views on taxation are explored in more detail in the following chapter.

**Communism**

Karl Marx rejected notions of traditional liberal individualism, the power of the market and the private ownership of property.

In the *Communist Manifesto*, Marx and Engels envisioned a society where “we shall have an association, in which the free development of each is the condition for the free development of all.”  

Marx proposed that equality could only be achieved between people by applying rights unequally.

> From each according to his capacity, to each according to his need.

This was the only way to compensate for the fact that people have different levels of ability, health, strength, number of children etc.

Marx proposed that if “the material conditions of production are the collective property of the workers themselves, then, naturally, a different distribution of the means of production from the present will result.” The concept of taxation would be redundant. Wealth in society would be gained ‘from each according to his capacity’ and distributed ‘to each according to his need’.

Even though the concept of tax would be redundant in the communist state, Marx envisioned that before the proceeds of labour were distributed for individual consumption there needed to be deducted;

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46 Ibid, p32
Firstly: the general costs of administration not appertaining to production.
Secondly: what is destined for the satisfaction of communal needs, such as schools, health services, etc.
Thirdly: funds for those unable to work, etc.\textsuperscript{47}

Marx defined freedom not in terms of freedom to own property or freedom to engage in market activities but thus:

Freedom consists in converting the state from an organ controlling society to one completely controlled by it.\textsuperscript{48}

Kautsky, commenting on Marx in 1922, recognised that “in the interval between the purely bourgeois administration and the purely proletarian administration of a democratic State there is a period of transition from one to another.”\textsuperscript{49} Marx also recognised the need for a period of transition and restated “the German Labour Party demands as \textit{an economic basis of the state} (author’s emphasis), a single progressive income tax.”\textsuperscript{50}

Richard Norman has examined the maxim ‘from each according to his capacity, to each according to his need’ and identified two problems.

Firstly, according to Norman, Marx is saying that rewards should be proportional to the amount of work which people contribute to society. This is because work should be rewarded ignoring the “unequal individual endowment”\textsuperscript{51} that each individual brings to the work. Norman believes that all people should be compensated in proportion to the ‘burden’ of work undertaken by each individual. This burden would be calculated by how much time is sacrificed to the work and an allowance made for dangerous or unpleasant work: Dangerous work such as underground mining or deep sea diving, unpleasant work such as that of the garbage collector or sewerage worker\textsuperscript{52}. Individuals should be free to shoulder a greater or lesser burden of work and, as a consequence of that decision, receive a greater or lesser amount of compensation.

\textsuperscript{47} Ibid, p28
\textsuperscript{48} Ibid, pp43-44
\textsuperscript{49} Ibid, p45 Footnote 43 quoting Kautsky
\textsuperscript{50} Ibid, p47
\textsuperscript{51} Norman R, \textit{Free and Equal: A Philosophical Examination of Political Values}, published by Oxford University Press, 1987, p115
\textsuperscript{52} Ibid, pp115-116
Secondly, if all in society were allocated goods according to their need, then there must be some rationing of goods for allocation. Norman sees “the drawback of such a system is that it leaves little room for individual choice”\textsuperscript{53}. Norman believes that equality of wealth could be achieved by “the communal provision of peoples’ basic needs, and other goods which are purchased by individuals according to their personal preferences.”\textsuperscript{54}

Norman’s restating of the Marx maxim becomes,

Free communal provision of goods to satisfy everyone’s basic needs, and beyond that, the distribution of wealth in such a way that everyone benefits equally overall from the work of the community on condition that, if they are able to do so, they participate in such work.\textsuperscript{55}

The socialist writer, RH Tawney saw taxation as the means to achieve Norman’s ‘equality of wealth’. Tawney stated,

It is … the pooling of its surplus resources by means of taxation, and the use of the funds thus obtained to make accessible to all, irrespective of their income, occupation, or social position, the conditions of civilization which, in the absence of such measures, can be only enjoyed by the rich.\textsuperscript{56}

**Social Liberalism**

Social liberalism originally developed as a reaction to issues and problems of classical liberalism of the seventeenth and eighteenth centuries and as a response to radical socialist and historical materialist ideas in the later nineteenth century. By this time the downside of the operation of free market relations, such as increasing polarisation of wealth and poverty and the distortion of emerging democratic politics by such increasing inequality, including the economic underpinnings of imperialism and pollution and destruction of the natural environment, were becoming apparent.

Arguably, as noted above, the last classical liberal and the first social liberal was John Stuart Mill. Later social liberals such as TH Green, JA Hobson and LT Hobhouse emphasised the

\textsuperscript{53} Ibid, p118  
\textsuperscript{54} Ibid, p119  
\textsuperscript{55} Ibid  
value of positive freedom to allow for the full development of individual capacities and the need for appropriate social support to make this possible.

Social liberals, or positive liberals, held that “the absence of direct coercion was a very inadequate idea of freedom. Individuals could be formally free and yet, caught in the toils of the market system, have little or no opportunity to develop their capacities or lead worthwhile lives. … To enjoy positive freedom, it was necessary to have an adequate minimum of resources and opportunities, particularly of an educational kind. If the opportunities were there, individuals would respond by developing their skills and interests in a positive and beneficial way.”57

Social liberalism or positive liberalism was articulated as a separate doctrine by LT Hobhouse in Liberalism written in 1911.58 Hobhouse “stressed the social factors involved in the creation of wealth”.59 Positive liberalism saw in the early twentieth century “the growth of public education, the beginnings of social security and unemployment relief, and a strengthening of the role of trade unions.”60

Later, social liberal ideas came to be associated with the English economist John Maynard Keynes. In his The General Theory of Employment, Interest and Money Keynes advocated the expansion of government expenditure in order to ameliorate “dangerous tendencies in capitalist economies”.61 The dangerous tendencies of capitalist economies were seen at the time, the period between the World Wars, as a tendency to recession and fascism62. Keynes’ views therefore managed to gain the support of both social liberals and conservatives. Keynes advocated an increase in government expenditure “in non-productive sectors of the economy such as transport, communication, education and health. Such expenditure would also be beneficial in other ways: improved transport and communication would help trade, and a literate and healthy work force would be more productive.”63

The political programmes of democratic socialist, labour and, more recently, Green parties, have attempted to realise social liberal ideas by expanding the welfare state with “social

57 Self P, Rolling Back the Market: Economic Dogma and Political Choice, as above, p47
58 Ibid, p39
59 Ibid
60 Ibid
61 Fink H, Social Philosophy, as above, p103
62 Ibid, pp101-102
63 Ibid, p103
security provisions, comprehensive health services and large public housing programmes
(seen as providing) basic material security, necessary for the positive freedom of all.

Social liberals see human rights not only as rights to be free from harm and interference, but also as rights to work, minimum pay, health, education and other basic needs. These are the positive rights of the kind expressed in the United Nations Declaration of Human Rights. The latest and most comprehensive social liberal movement sees human rights as the right of all humans to a “life economy.” The life economy espouses the positive human rights of traditional social liberals and adds to those the right to a sustainable planet for all to inhabit. The life economy principle of justice is expressed as;

Justice across realms: self-organising, life-space reclamation across unused and misused arable lands, forests and fisheries, safety of urban concourses and coastal waterways, and public education and policy sites in accordance with codified life-standards.

Social liberals followed the classical liberals in seeing human natures’ creative potential which needs to be liberated from excessive restriction and restraint so it can contribute to overall social welfare through profit seeking activities. Social liberals however, also recognised human need, the integral role of need satisfaction in human life and human fulfilment. This requires social intervention in free market operations because the free market fails to ensure basic need satisfaction for all. In a world of limited resources the unconditional protection of ownership rights can deny many the actual means of survival. Classical liberals focussed on criminal legal sanctions and civil compensation for trespass to the person in the form of assault or homicide. Social liberals focussed on the collective social protection and preservation of human life through the active provision of the objects to meet human needs as well as the classical liberal focus.

From this social liberal perspective human rights are seen as ethically grounded insofar as they are rights to objects of need, to the things that all humans must have to survive and live a fulfilled life. If people are denied access to the things they need they will suffer in more or less serious ways. These human rights imply a universal responsibility for all to respect and facilitate those rights.

64 Self P, Rolling Back the Market: Economic Dogma and Political Choice, as above, p38
66 Ibid, p218
In line with their focus on the necessity of need satisfaction, and the recognition of the limitations of unregulated capitalist market relations in ensuring need satisfaction, social liberals came to see the crucial importance of equality of access to the material means of need satisfaction, rather than mere absence of legal restrictions on individuals rights to pursue the satisfaction of their needs and wants.

Social liberals recognise a broader range of basic human rights calling for legal support than those identified by classical liberals. These include positive rights for

1. Workers – the right to be able to work, to decent pay, decent working conditions, to form and join unions, collectively bargain, engage in strikes and pickets.
2. Consumers – the right to goods and services that are suitable for their purpose, not harmful, and the right to be informed about the nature of the goods, eg a list of ingredients.
3. Parents – the right to paid maternity and paternity leave, education for their children
4. Residents and citizens – the right to health care, welfare services, housing, appropriate infrastructure to provide transport, clean water, affordable power, access to telecommunications and legal representation.

These rights impose obligations and duties on the state, employers, producers and fellow citizens. Social liberals recognise that in order for these rights to be realised those individuals benefiting disproportionately from private property rights and the operation of the free market have to accept responsibilities towards those who have not benefited. The classical liberal, Adam Smith’s first maxim of taxation was that the “subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”

This encapsulates the classical liberal view of just deserts. A persons’ ability would be matched with a persons’ revenue and every person should pay proportional tax according to their ability. Social liberals, on the other hand, believe that those benefiting disproportionately from the operation of the free market should support the state disproportionately. That is, social liberals believe in progressive income and property taxes, and market regulation in order to provide the public funding and economic stability necessary for the enforcement and support of universal rights, including as employment, health care, education, welfare and product regulation.

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Social Liberalism and Justice

Social liberals recognise that because humans can only satisfy their needs and reach their potential in and through existing social structures and relations, there is an ethical imperative for those with social power to ensure social structures and relations satisfy those needs. In practice, this means providing protection from unemployment, inequality, prejudice and access to health care and education. It also means providing opportunities for realising human potential through satisfying work, sport, literature, art, science and meaningful political participation. Justice is more than the classical liberal idea of justice as being formal or procedural legal equality. Justice for social liberals means recognising that formal legal equality can produce unjust outcomes. For example, it is unjust to impose the same penalty on a wealthy white collar criminal who steals and the homeless person who steals. In reality, of course, the white collar criminal who steals far more than the homeless person almost always receives a much lesser sanction than the homeless person.

In the area of distributive justice social liberals hold that it is unfair for the individual whose privileged social position has allowed them to acquire professional skills to receive a substantially greater reward for hours worked than someone whose social position denied them the opportunity to acquire such skills.

The social liberal focus is on striving to provide equality of reward for socially useful effort and sacrifice and on equality of outcome in terms of equal fulfilment of need and equal realisation of human potential.

Different Approaches to Economic Justice

Robin Hahnel in his *Economic Justice and Democracy* postulated four maxims of economic justice. These maxims can be seen as a logical conclusion of the major economic theories; classical economic theory, social liberal economic theory and conservative or neoliberal economic theory.

While Hahnel postulates these four maxims of justice it appear that the first two maxims actually reflect the classical liberal and neoliberal views of justice and maxims three and four reflect social liberal views.

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68 Mann S, *Unpublished work in progress*
69 Ibid
Maxim 1: “To each according to the value of the contribution of her physical and human capital”\textsuperscript{71}.

The economic rationale behind this maxim is the classical liberal rationale of just deserts, that is, “people should get out of an economy what they and their productive possessions contribute to the economy.”\textsuperscript{72} This maxim is the logical conclusion of the classical position, that “in a (competitive) market economy labour and capital, just like all other commodities, receive payments consistent with their marginal productivity.”\textsuperscript{73}

In reality markets are rarely competitive, and markets take no account of the power imbalances between the providers of value, that is between labour and capital. The just deserts rationale also makes the untenable assumption that ‘initial endowments of private property are just and natural’\textsuperscript{74}. Hahnel calls the initial endowments assumption “the Rockefeller grandson problem”\textsuperscript{75} to highlight the untenability of the assumption.

Maxim 2: “To each according to the value of the contribution of only her human capital.”\textsuperscript{76}

The economic rationale behind this maxim is also the classical rationale of just deserts, but it removes the unsustainable assumption of initial endowments of private property. As Hahnel points out, there are two major objections to this maxim.

Firstly, initial endowments of personal attributes, such as a sporting physique or a high intelligence are beyond the control of the person receiving or not receiving those attributes. There is no justice in the distribution of personal attributes it is a function of genetic luck\textsuperscript{77}.

Secondly, it is considered justice for people with more training and education to be rewarded more than those with little or no training or education because of the ‘sacrifice’ made to undertake such training or education. Hahnel states this argument is flawed on two counts. One, it is questionable whether being a student as opposed to being in employment is actually a sacrifice as a students’ life is usually more pleasant than that of a worker. Two, the major cost of providing education and training is a public expense therefore the public is...

\textsuperscript{71} Ibid, p19
\textsuperscript{72} Ibid
\textsuperscript{73} Varoufakis Y, \textit{Foundations of Economics: A Beginners Companion}, as above, p183
\textsuperscript{74} Paraphrasing EK Hunt, above and from Hunt E K, \textit{History of Economic Thought: A Critical Perspective}, as above, p307
\textsuperscript{75} Hahnel R, \textit{Economic Justice and Democracy}, as above, p19
\textsuperscript{76} Ibid, p25
\textsuperscript{77} Ibid
making the greater monetary ‘sacrifice’ not the student, or her family, and the public should be compensated by the services of a well trained and well educated person.\textsuperscript{78}

Maxim 3: “To each according to her personal effort, or personal sacrifice.”\textsuperscript{79}

The economic rationale behind this maxim reflects the classical liberal rationale of good taxation as envisaged by John Stuart Mill in chapter 2 below. Mill thought that ‘equality of taxation meant equality of sacrifice’. The taxation policy that Mill envisaged that would best reflect this equality of sacrifice was one where there were:

- Progressive taxes on inherited property to mitigate inequalities of wealth and opportunity that arose from inheritance.
- Unearned incomes, incomes from rents or dividends, were taxed at higher rates than taxes from personal exertion. Mill argued that people earning a living from providing their labour would need to provide for income in their old age, whereas landlords or shareholders had no such need.
- Progressive taxes on incomes that increase without any sacrifice on the part of owners, that is, on rents and dividends that increase without any further investment from the owners of that property/income.

Hahnel holds that this maxim “simply balances any differences in the burdens people choose to bear with commensurate differences in the benefits they receive.”\textsuperscript{80} He continues “I think this is the strongest argument for reward according to sacrifice”\textsuperscript{81} even though there are valid differences in how to measure and compensate sacrifice between people.\textsuperscript{82} The major disadvantage of this maxim according to Hahnel is that it makes no provision for people who are unable to make economic sacrifices so as to be able to earn income, for example, people who may be ill, aged, children, suffer a disability, unemployed etc. Mill’s ideal taxation makes allowance for people to put funds aside for their old age but it does not provide for other categories of people unable to make economic sacrifices.

\textsuperscript{78} Ibid, p26
\textsuperscript{79} Ibid, p27
\textsuperscript{80} Ibid, p28
\textsuperscript{81} Ibid
\textsuperscript{82} Ibid, p29
Maxim 4: “To each according to her need.”

The economic rationale behind this maxim reflects the social liberal rationale of human rights and justice and the Marxist rationale of a just society.

The social liberal view of justice is for the positive provision of human rights for all in society. Social liberals recognise that, “as humans can only satisfy their needs and reach their potential in and through existing social structures and relations, there is an ethical imperative for those with social power to ensure those social structures and relations do satisfy those needs. In practice, this means providing protection from unemployment, ill-health, inequality, ignorance and prejudice.” Social liberals also recognise that markets fail to provide for human needs and that taxation discussed in chapter two, recognises that redressing the negative impact of market failings is the responsibility of the state. Taxation must be used as a tool to redress the failings of the market.

The Marxist position on justice is society provide “From each according to his capacity, to each according to his need.” Marx recognised that equality could only be achieved between people not by applying equal rights, for example, the right to equal pay for equal work, but by applying rights unequally. This was the only way to compensate for the fact that people have different levels of ability, health, strength, number of children etc.

Allowing the final word to Hahnel, “it is our sense of justice that requires rewarding greater sacrifice, whereas it is our humanity that compels us to provide for those in need.”

**Human Needs and the Importance of Redressing Material Inequality**

Even if a society such as Australia is sufficiently wealthy to be able to provide for the physical human needs of its members, in the tradition of social liberalism, the society should also strive to reduce inequalities between the members of its society. Norman states that in an ideal society that people have a right to have their physical needs met. Although needs, wants, situations and abilities between people are unequal, societies can strive to minimise material inequality between the people in their borders. Minimising material inequality is

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83 Ibid, p31
84 Mann S, *Unpublished work in progress*
86 Ibid, p30
87 Hahnel R, *Economic Justice and Democracy*, as above, p32
important because “there is considerable evidence that societies which have the greatest
differentials in wealth and income are also the most unequal in access to other resources,
including power and influence.”\textsuperscript{88} “Empirical data from around the world also provides
strong evidence of significant correlations between inequality, homicide and violence as well
as inequality, illness and mortality”\textsuperscript{89} within societies.

Classical liberals consider economic inequality to be good because it provides the necessary
stimulus to maximise ‘productive effort, initiative, innovation and the best use of available
resources to maximise efficiency and output.’

Some studies postulate that economic inequality, even in a wealthy society where basic
human needs are able to be met, are detrimental to the quality of life and mortality rates. In a
society where there is little inequality between members all members of the society benefit
because of reduced rates of violent crime and by improved health and mortality rates.

Michael Marmot in \textit{Status Syndrome}\textsuperscript{90} interprets evidence, which may demonstrate that once
the basic human needs of food, shelter and sanitation have been met, “how much money you
have is not as important as how much you have in relative to others in society”\textsuperscript{91} as an
indicator of health outcomes. “For example, the US, which has the highest GDP (gross
domestic product) in purchasing power (except for Luxembourg), ranks twenty-sixth in life
expectancy.”\textsuperscript{92}

\textsuperscript{88} Lawrence C, \textit{The Scourge of Inequality: global and Australian trends}, a public lecture given at
Murdoch University, 26 April, 2000, \url{http://about.murdoch.edu.au/lectures/inequality.html} at 1 of 15
\textsuperscript{90} Marmot M, \textit{Status Syndrome: How your social standing directly affects your health and life
expectancy}, published by Bloomsbury, Great Britain, 2004
\textsuperscript{91} Ibid, p67
\textsuperscript{92} Ibid, pp67, 68

\begin{center}
\begin{tabular}{lcc}
\textbf{Country} & \textbf{Life expectancy at birth} & \textbf{GDP per person} \\
Japan & 81.3 & 25,130 \\
Sweden & 79.9 & 24,180 \\
Canada & 79.2 & 27,130 \\
Spain & 79.1 & 20,150 \\
Switzerland & 79.0 & 28,100 \\
Australia & 79.0 & 25,370 \\
Israel & 78.9 & 19,790 \\
Norway & 78.7 & 29,620 \\
France & 78.7 & 23,990 \\
Italy & 78.6 & 24,670 \\
Netherlands & 78.2 & 27,190 \\
New Zealand & 78.1 & 19,160 \\
Malta & 78.1 & 13,160 \\
Greece & 78.1 & 17,440 \\
Cyprus & 78.1 & 21,190 \\
\end{tabular}
\end{center}
Marmot then emphasises that absolute wealth is not the determinant in health outcomes by the following example: the average income of African-Americans in the US is $26,000 per person. “They are by world standards, rich. Yet, life expectancy for US blacks is 71.4, below that of poor countries such as Costa Rica (77.9) or Cuba (76.5).”

In other words, the arguments often put forward that politics and politicians should be concerned about the health of the economy as a whole because a better economy, that is, with a high GDP is good for the health of the people is just not true. It is, once basic needs have been met, more important for the health of people that they live in a country where there are low wealth and income disparities than in a wealthy country.

Even though the taxation system does not cause disparities in wealth and income, the taxation system can be a powerful tool in redressing wealth and income disparities or in entrenching them. The taxation system cannot be a tool for providing a community with negative rights, which can be expressed as ‘freedom from’. Freedom from exploitation, torture, violence etc can only be provided by legal guarantees backed up by strong legal sanctions and the approbation of a society that makes these violations unacceptable. Of course, having sufficient funds to provide legal sanctions is useful.

On the other hand, positive human rights do require material resources to be divided among a population so that all members of a population have their positive rights met. In this context how a society taxes, that is to either ameliorate disadvantage or to entrench advantage, is vitally important.

The Blair government in 1997 “set up an Independent Inquiry into Inequalities in Health under the chairmanship of a former Chief Medical Officer, Sir Donald Acheson” which produced the Acheson report in 1998. Michael Marmot was a member of this committee. After making two general recommendations the first specific recommendation was:

<table>
<thead>
<tr>
<th>Country</th>
<th>Life Expectancy</th>
<th>Income per Person</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>78.0</td>
<td>25,350</td>
</tr>
<tr>
<td>UK</td>
<td>77.9</td>
<td>24,160</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>77.9</td>
<td>9,460</td>
</tr>
<tr>
<td>Singapore</td>
<td>77.8</td>
<td>22,680</td>
</tr>
<tr>
<td>US</td>
<td>76.9</td>
<td>34,320</td>
</tr>
<tr>
<td>Ireland</td>
<td>76.7</td>
<td>32,410</td>
</tr>
<tr>
<td>Cuba</td>
<td>76.5</td>
<td>5,259</td>
</tr>
<tr>
<td>Portugal</td>
<td>75.9</td>
<td>18,150</td>
</tr>
</tbody>
</table>

93 Ibid, p68
94 Ibid
95 Ibid, p259
96 Ibid, p267 The two general recommendations were;
“We recommend policies which will further reduce income inequalities, and improve living standards of households in receipt of social security benefits”

Neoliberalism

In recent decades there has been a major reaction against social liberalism and a return to an ideology closer to the ideology of the classical liberals – neoliberalism. The neoliberal or neoclassical approach to human rights has become the dominant ideology from the 1980’s up to the present day in western capitalist societies. Neoliberalism’s profound importance in shaping world opinion and world events in recent decades makes it crucial to understand neoliberal ideas. The foundation of neoclassical economics and neoliberalism is the underlying “assumption that all economic behaviour is based on selfish, acquisitive motives”.

Contemporary neoliberals support the common law tradition in according special status to the rights of private property and the rights to bodily integrity. Property rights being the rights of exclusive control and possession and the rights to buy and sell legitimately acquired property. While these rights are essentially negative rights, neoliberals’ accord particular significance to the property rights of major productive resources of land and technology as these are the means of social wealth creation. In practical terms this means that while thefts of personal property are investigated by the police, any threats to productive assets are protected by a show of force from the state. This is seen whenever there are factory pickets, workers marches or occupation of work sites by striking workers. A recent example is the show of force by a large police presence in 1998 when the Australian government attempted to ‘break’ the Maritime Union of Australia on behalf of a private employer.

Neoliberals reject the idea that any extra social responsibilities or duties attach to those who derive benefits by virtue of having their property rights accorded protection. Neoliberals hold that ownership of substantial private property carries no special responsibility to support the public services made available to others with much less property. For example, the right of

1. We recommend that as part of health impact assessment, all policies likely to have a direct or indirect effect on health should be evaluated in terms of their impact on health inequalities, and should be formulated in such a way that by favouring the less well off they will, wherever possible, reduce such inequalities.
2. We recommend a high priority is given to policies aimed at improving health and reducing health inequalities in women of child-bearing age, expectant mothers and young children.

98 Boland S, ‘Stakes high for all workers in wharf dispute’, Green Left Weekly, 2 April 1998
free speech is available to all in society. This right, when exercised by a newspaper publisher, carries no special responsibilities to ensure fair and balanced treatment of the issues of the day with the presentation of diverse perspectives. Similarly, people in positions of political and economic power owe no special duties toward the powerless to, for example, reduce inequality, expand social services or protect the natural environment. Neoliberals see no contradiction in the belief that owning substantial productive property entitles the owners to special and ‘extra’ protection provided by the state but carries no ‘extra’ responsibility to the state which provides that protection.

Neoliberals see the task of the state as essentially (except where it comes to protecting productive property) a negative one. The task of the state is to ensure that there is no direct discrimination between people and that there are no impediments to the free market exchange of goods and services. However, neoliberals do not, generally, support direct state intervention to address the economic discrimination that prevents or limits human participation in the free market. For example, if people fail to acquire the material resources to pay for higher education, good health or dental care, or experience joblessness, neoliberals do not support state intervention to make up such lack of material resources. Neoliberals believe the onus is on individuals to acquire the material resources necessary to pay for such things in a free market through their own market contributions, that is, by making available their strength, skills and material assets, at market value, for useful productive work. However they do desire the state to provide infrastructure including a skilled workforce.

A neoliberal government will facilitate employment through policies of microeconomic reform, such as motivating employers to employ more workers by increasing employer tax breaks, providing employment subsidies and increasing employers powers over the employment contract (by abolishing minimum wages, or making collective bargaining illegal). The central bank could also contribute by manipulating interest rates to encourage growth without inflation. However, if the government were to guarantee employment by becoming the employer of last resort neoliberals would hold that this would undermine free market competition and efficiency. Neoliberals hold that the unemployed are unemployed either because they lack the skills demanded by the market and should acquire those skills, or they are demanding too much pay for their labour and should moderate their pay demands. However the central bank as the lender of last resort to the private banking system is not seen by neoliberals as undermining free markets.

99 Mann S, Unpublished work in progress
100 Ibid
This neoliberal approach and its impact on taxation were articulated by Milton Friedman in Australia in 1981. Friedman understood that it is a role of governments to uphold the human rights of their citizens. He expressed the liberal and social liberal view of human rights thus:

What is the appropriate role of government? Is it, as Adam Smith urged, to construct a system of natural liberty in which people are free to pursue their own ends, in which the invisible hand will lead people who seek to pursue only their own interests to promote the social interest? Or is the appropriate role of government, as the Fabian socialists and the other collectivists would tell you, to serve as a benevolent parent to make sure that its wards act in a way which is in their own best interest? It is to have a very visible hand of government which prevents the invisible hand from carrying out its functions and which guides people in the course of their lives?\textsuperscript{101} Friedman recognises that the role of government is “reflected in turn in the extent of taxation”\textsuperscript{102} and in the type of taxation imposed by government. As will be seen in the following chapter Friedman advocates no taxation of companies.

**The Two Different Approaches to Human Rights**

The two fundamentally different approaches to human rights reflected in political policies today are the views of the classic liberal and neoliberal thinkers and those of the social liberals. These approaches to human rights are also the two different approaches to economic thought. The dominant approach, either social liberal or neoliberal, prevailing in society at any one time shapes attitudes to the provision of human rights, the funding required for such provision and the taxation policies acceptable to society.

The two different approaches to human rights are essentially;

1. The classic liberal and neoliberal approach as expressed in the European Convention, also called negative rights or first generation rights. Norman, the humanist states that “The European Convention, for instance, is essentially a list of negative rights – rights to be allowed to do certain things, and rights not to be treated in certain kinds of way. They include the right to life, rights not to be tortured or enslaved, and rights to freedom of thought and freedom of expression.”\textsuperscript{103}

\textsuperscript{101} Friedman M, *Taxation Inflation and the role of Government*, published by the Centre For Independent Studies, 1981, Australia, p4

\textsuperscript{102} Ibid

This form of human rights essentially equates with the narrow view of justice that only allows for equality before the law.

2. The social liberal approach as expressed in the United Nations Declaration of Human Rights adds to the negative rights positive rights also called second generation rights. These include “the right to social security, to equal pay, to rest and leisure, to education, and to a standard of living adequate for the health and well-being of oneself and one’s family.”

This form of human rights essentially equates with the broader view of rights as rights that allow all human beings to function optimally as human beings.

In between those two approaches are the views of the philosopher and economist John Stuart Mill. Mill is quoted with approval by both the classical and neoliberals and the social liberals.

In his *The Critique of the Gotha Programme* Marx, considering human rights stated that in a capitalist society human rights are “in every respect tainted economically, morally and intellectually”. The taint, according to Marx was the attempt by the German Social Democrats to fashion human rights as rights to ‘part of the proceeds of labour’. The German Social Democrats envisioned rights as; individuals receiving from society a voucher that he/she has contributed a certain quantity of work and is thus entitled to draw “on the social storehouse as much of the means of consumption as the same quantity of work costs.” Marx recognised that this as the commodification of labour and that equal rights in this context “are based on the same principles as bourgeois right”, that is:

> Here obviously the same principle prevails as that which regulates the exchange of commoditites so far as this exchange is of equal values.

Capitalist based rights to wages for labour, even if enshrined in minimum wages legislation will never be more than “a right of inequality” because rights in capitalist terms can by their “very nature only consist in the application of an equal standard” to individuals who are by their very nature unequal. Individuals have different intellectual and physical

\[104\] Ibid
\[105\] Marx K, *The Critique of the Gotha Programme*, (1933), p29
\[106\] Ibid
\[107\] Ibid
\[108\] Ibid
\[109\] Ibid, p30
\[110\] Ibid
capacities and different needs for income, for example the person with no dependant or special needs compared to the person with dependant and special needs. According to Marx therefore, “rights must be unequal instead of being equal.”

In this part of his critique Marx concludes that

Right can never be higher than the economic structure and the cultural development of society conditioned by it.

This thesis recognises the operation of taxation law in a capitalist western construct and any conclusions made are limited to the ‘economic structure (capitalism) and cultural development’ (western) of the society in which the conclusions are made, that is, the here and now.

Positive and Negative Liberals

Peter Self in *Rolling Back the Market: Economic Dogma and Political Choice* uses the term positive and negative liberals to describe the split that occurred in liberal thought in the late nineteenth century. Self states, “positive liberals differed from the negative ones in having a more positive view of freedom and equality, and in being prepared to enlist government for these purposes. The negative liberals stayed with a strong faith in the beneficence of capitalist markets and an equally strong distrust of government action beyond the necessity for a few basic laws and services.”

The presently dominant view of capitalism, the neoliberal view in relation to taxation policy does two things. Firstly, it shapes taxation policy. Secondly, it shapes what the taxpayers regard as ‘fair’. The prevailing “psychology of justice” is important because it influences the level of tax compliance by taxpayers. Commenting on the situation in the US, Wenzel notes that “failure to comply with tax laws costs states billions of dollars each year, thus impacting severely on their provision of government services and their socio-economic

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111 Ibid
112 Ibid, p31
114 Ibid, p33
116 Ibid
functioning.” In Australia, the absolute magnitude of the impact of non compliance on government revenues may be less than in the US, but, the negative impact on the provision of government services would be similar. The other impact of non compliance with tax laws is that the tax burden is pushed onto those taxpayers who are complying with the laws further increasing the sense of injustice. An increasing sense of injustice by taxpayers increases the proportion of taxpayers who fail to comply with tax laws increasing the levels of non-compliance. Empirical evidence reviewed by Wenzel has shown that even though research on tax evasion has up till the present been dominated “by individualistic approaches that focus exclusively on the motivation to maximise personal material outcomes” this “pure self-interest account is insufficient for a proper understanding of taxpayer behaviour” with respect to compliance and non-compliance with tax laws.

In defining the features of human rights Nickel states that “as a minimum it means that human rights have rightholders (the people who have them); addressees (parties assigned duties and responsibilities); and scopes that focus on a freedom, protection or benefit.” The two views of human rights, the neoliberal and the social liberal views both go to defining the scopes of human rights. The primary addressees of human rights are governments, in other words human rights “set standards of decent governmental conduct.” The imperative of human rights imposes on governments duties to refrain from acting in certain ways, for example to discriminate and imposes duties on governments to act in certain ways, for example to provide decent social welfare. These duties require revenue and revenue requires taxation.

**Conclusion**

This thesis proposes a human rights or equity perspective and rejects the subordination of society to market efficiency. It is in favour of a more social liberal approach. The social liberal view of human rights as second generation rights requires taxation as an integral source of funding those rights: the rights to the necessities of life as well as rights to health, education a clean and sustainable environment. Justice is central in terms of equal protection of the human rights of all. Efficiency in these terms includes the efficient achievement of such justice. Utility is considered in terms of objective measures of need satisfaction and life

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117 Ibid
118 Wenzel M, ‘Tax Compliance and the Psychology of Justice: Mapping the Field’, as above, p44
119 Ibid, p60
120 See Appendix A Corporations as Rightholders. The theories of the corporation are explored and corporations in Australian law are recognised as rightholders that need to be taxed fairly.
122 Ibid, p10
outcomes. It will be argued that taxation policy should also become an effective tool to redress inequality in society.

It is proposed that a good tax system needs to be equitably and fairly imposed between taxpayers because the major motivating factor leading to tax avoidance is the perception by taxpayers that they are not being treated ‘fairly’ and widespread tax avoidance can undermine the integrity of a taxation system. “A June 1998 survey of 1000 Australians commissioned by the Australian Taxation Office (ATO) found that only 32 per cent believe ‘tax laws are effective in making sure large companies pay their share of tax’…and …. Only 20 per cent believed ‘the ATO does a good job stopping tax avoidance by large companies’.”123 In other words, 68% of the survey respondents believe that Australian tax laws are ineffective when it comes to the taxation of large companies and 80% believe that the ATO is not good at stopping tax avoidance by large companies. It will be further argued that the major tax avoiders are large companies not ordinary taxpayers.

A good taxation system should also promote human rights, which encompass more than utilitarian economic efficiency arguments.

Human rights encompasses more than maximising spending power. Human rights have to do with human measures and values such as mortality, crime rates, and access to clean air, water, adequate nutrition, shelter, health and education.

This thesis examines the direct taxation of the profits of companies, in particular in Australia. In this examination it considers the relationship between economics, ethics and the law.

This thesis challenges assumptions about a just and socially useful taxation system and offers suggestions for taxing the profit of companies.

The next chapter examines how the classical and neoliberal approach to human rights has shaped the classical liberal and neoliberal approach to taxation and equity in taxation. The chapter also examines how the social liberal approach to human rights has shaped the social liberal approach to taxation and equity in taxation. The views of JS Mill are examined here as a forerunner to the social liberal approach to taxation.

Chapter 2 The current neo-liberal, the classical liberal and social liberal positions with respect to the taxation of corporations

Introduction

In this thesis taxation, as argued in the first chapter, is a human rights issue. This chapter is concerned with the current neo-liberal, the classical liberal and social liberal positions with respect to the taxation of corporations. Most discussion in taxation neglects discussion of the ethics of taxing corporations. Yet, corporations are treated as legal persons and are also significant taxpayers. In Australia in 2002-03 income taxes levied on enterprises (mostly company tax) represented 19.9% of total Commonwealth government taxation revenue and 16.3% of the revenue of all levels of government\textsuperscript{124}.

This chapter examines and evaluates the application of various theories of equity and justice developed by economists and philosophers to the issue of what constitutes an ethically fair tax contribution by corporations.

A balance between what the corporations see as an equitable contribution and the taxing jurisdiction determines is an equitable contribution must be found. This balance must be found so that corporations will actually pay the taxes levied on them by the taxing jurisdiction. Corporations need labour, materials, infrastructure and markets, nations need employment, goods and services and access to international markets.

The Purposes for which Taxes are raised

One of the earliest papers written about taxation and the need for taxation was \textit{A Treatise of Taxes and Contributions} written in 1662 by Sir William Petty. Petty was a doctor, an associate of the philosopher Thomas Hobbes, one of the founders of the Royal Society and an ally of Cromwell who surveyed the lands of Ireland for the Cromwellian army\textsuperscript{125}. Chapter 1 of the treatise is called “Of the Several Sorts of Publick Charges” and lists what Petty considered to be acceptable types of public expenditures that ought to be undertaken by the state. Petty lists the following expenditures;

\begin{itemize}
\item \textsuperscript{124} Australian Bureau of Statistics, 2005 \textit{Year Book Australia Number 87}, published by the Commonwealth of Australia, 2005, p743
\item \textsuperscript{125} DP O’Brien, editor, \textit{The History of Taxation, Volume I}, published by Pickering and Chatto, London, 1999, p2
\end{itemize}
1. Defence expenditures to maintain the peace from injuries that could arise from foreign states and from internal sources such as civil unrest or crime.

2. The maintenance of a public service at a “competent reward”\(^\text{126}\). Public servants were listed by Petty to include Governors, Sheriffs, Justices of the Peace, Constables, and Churchwardens etc.

3. The administration of justice

4. Schools and universities. The reason Petty gave for schools and universities to be financed by the public and not private purse is a reason still given for the support of public education, that is, “The which Wits should not be selected for that work (learning), according to the fond conceits of their own Parents and Friends, (Crows that think their own birds ever fairest) but rather by the approbation of others more impartial; such as they are, who pick from out of the Christian Children the ablest Instruments”\(^\text{127}\).

5. The maintenance of orphans

6. The maintenance of beggars

7. The maintenance of infrastructure expressed as “Highways, Navigable Rivers, Aqueducts, Bridges, Havens, and other things of universal good and concernment.”\(^\text{128}\)

8. Any “Other Branches (that) may be thought on…over and above”\(^\text{129}\)

Petty specifically excluded the maintenance of religious establishment from his list of matters to be paid by the public purse on the following ground: “the particular interest of each man there should not be a Publick Charge in this”\(^\text{130}\).

The uses of public expenditure have essentially remained unchanged since Petty wrote his list even though they are expressed in different terms today. The modern Australian taxpayer expects a more sophisticated level of public services and public goods than the taxpayer of the 17th century and this is reflected in the increased taxation revenues collected as a proportion of Gross Domestic Product (‘GDP’).


\(\text{127}\) Ibid, the Petty Treatise, Chapter 1, paragraph 10

\(\text{128}\) Ibid, the Petty Treatise, Chapter 1, paragraph 13

\(\text{129}\) Ibid, the Petty Treatise, Chapter 1, paragraph 14

\(\text{130}\) Ibid, the Petty Treatise, Chapter 1, paragraph 7
The Australian Public Accounts for the year 2001-02 show the following public expenditures:\(^\text{131}\);

1. General Public Services. This includes expenditure on legislative and executive affairs, financial and fiscal affairs, foreign affairs and economic aid, general research, general services and government superannuation benefits.

2. Defence
3. Public order and safety
4. Education
5. Health
6. Social security and welfare
7. Housing and community amenities
8. Recreation and culture
9. Fuel and energy
10. Agriculture, forestry and fishing
11. Mining and mineral resources (other than fuels), manufacturing and construction
12. Transport and communications
13. Other economic affairs, including tourism, labour and employment affairs
14. Other purposes, including public debt interest, superannuation interest, intergovernmental transactions, natural disaster relief, contingency reserve and asset sales

The list of public expenditures proposed by Sir William Petty in 1662 and the list of actual expenditures undertaken by the Australian Commonwealth government in 2001-02 are very similar. Surprisingly, not only are the types of public expenditure proposed over 340 years ago the actual expenditures being made today, but, the order of importance of expenditures listed so long ago is still much the same order of importance today.

The only significant difference in public expenditures is that in modern times it has become acceptable for public funds to provide welfare for business ventures and thus for corporations. Expenditure items numbered 9 to 13 in the Australian public accounts are all payments that directly support ‘private enterprise’.

Even though the way taxes are spent has remained virtually unchanged over the past 340 years except for the inclusion of payments to support private enterprise, the amount of taxes

\(^{131}\) Final Budget Outcome, 2001-02, published by the Commonwealth of Australia, Canberra, ACT, 2002, from the table, Commonwealth general government expenses by function, p6
raised and the way taxes are raised has changed dramatically. This can be seen from the table below.

Table 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Commonwealth Taxation Revenue as % of GDP</th>
<th>Total Taxation Revenue as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1901-02</td>
<td>4.05</td>
<td>6.32</td>
</tr>
<tr>
<td>1908-09</td>
<td>3.83</td>
<td>6.22</td>
</tr>
<tr>
<td>1918-19</td>
<td>6.05</td>
<td>9.42</td>
</tr>
<tr>
<td>1928-29</td>
<td>6.68</td>
<td>12.32</td>
</tr>
<tr>
<td>1938-39</td>
<td>8.22</td>
<td>15.38</td>
</tr>
<tr>
<td>1948-49</td>
<td>22.55</td>
<td>27.80</td>
</tr>
<tr>
<td>1958-59</td>
<td>17.88</td>
<td>21.28</td>
</tr>
<tr>
<td>1968-69</td>
<td>18.20</td>
<td>21.82</td>
</tr>
<tr>
<td>1978-79</td>
<td>20.74</td>
<td>26.03</td>
</tr>
<tr>
<td>1988-89</td>
<td>23.68</td>
<td>29.56</td>
</tr>
<tr>
<td>1998-99</td>
<td>23.29</td>
<td>30.13</td>
</tr>
<tr>
<td>2001-02</td>
<td>25.48</td>
<td>31.18</td>
</tr>
</tbody>
</table>

In modern Australian society, individuals, social welfare groups and business groups, have expectations about what is an acceptable standard of infrastructure. There are also expectations that governments provide much of the infrastructure. These expectations have seen a steady increase in taxation revenue as a percentage of GDP in Australia. Taxation revenue as a percentage of GDP in 1918-19 and 1948-49 was higher than the normal upward trend because of the effects of World War 1 and World War 2. The upward trend slowed in the 1980’s to the late 1990’s because of the ascendancy of neoclassical ideology in Australian governments.

In Australia there are private schools, hospitals, roads, airports, rail links, electricity suppliers and telecommunication suppliers all of whom rely substantially on Government funding. This funding comes in the form of recurrent funding, prior infrastructure investment or ad hoc injections of funds.

By the year 2000 the conservative Australian Commonwealth government needed to increase revenues to meet public expectations. Therefore, in 2001-02 the Commonwealth introduced a value added tax, called Goods and Services Tax (‘GST’) at a flat rate of 10% on all goods

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133 Australian Bureau of Statistics, 2004 Year Book Australia Number 86, published by the Commonwealth of Australia, 2004 at pp 741 and 763
and services sold at the retail level. This GST replaced a system of targeted wholesale taxes. The effect of the GST on the Commonwealth share of revenue was to increase its share. The accounts issued by the Commonwealth government show that the Commonwealth’s share of taxation revenues as a percentage of GDP was 24.0% in 2000-01 and it increased to 26.5% in 2001-02 the first year of the introduction of the GST. This is not directly comparable to the ABS statistics but does provide an explanation of the large jump in the Commonwealth share of revenue in 2001-02 as compared with 1998-99.

Classical Liberal view of Taxation

Sir William Petty
Petty in his 1662 treatise on taxation devoted a chapter on “How the causes of the unquiet bearing of Taxes might be lessened”. This chapter highlighted that “what angers men most, is to be taxed above their neighbours”. Petty then analyses how men might be taxed equitably so as to minimise any sense of injustice between them. He states that taxes should be “proportionable unto all” men so that all men “remain equally rich”. Petty’s argument is that if the estates of all wealthy men were halved, by taxation, then “each man would have his former state, dignity and degree”. Petty can only see wealthy, landed gentry being taxed and states that taxes maintain the wealth of the country by the King redistributing from the landed classes to the working classes via employment. Petty gives the examples of taxes paying for the upkeep of the Navy and for Royal fetes and exhibitions.

Since Petty, discussion of ‘how men might be taxed equitably’ has largely remained just that: a discussion of equity between persons. Although persons legally includes corporations practically no discussion of taxation equity considers the position of corporations.

Adam Smith
In the Wealth of Nations Adam Smith developed four maxims that he considered necessary to a good tax. The first and most important of these maxims was what Smith called the observation of “the equality or inequality of taxation”. Smith’s four maxims were:

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134 Final Budget Outcome 2001–02, Commonwealth of Australia, September, 2002
135 DP O’Brien, editor, The History of Taxation, Volume I, as above, title of Chapter III, p30
136 Ibid, p31
137 Ibid, p30
138 Ibid
139 Ibid, pp30-31
140 Ibid, pp30-35
I. “The subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”  

II. “The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person. … The certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, I believe, from the experience of all nations, is not near so great an evil as a very small degree of uncertainty.”

Smith believed that uncertainty in taxation would lead to taxpayers being extorted by tax collectors and that taxpayers would be encouraged to corrupt tax collectors. The evils of extortion and corruption were to Smith greater than the evil of inequality. In most western capitalist nations the existence of a decently paid civil service has largely gotten rid of the evils that Smith had observed in his day.

III. “Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.”

To illustrate this maxim Smith spoke with approval of taxes upon consumable luxury items that should be paid for by the consumer as he buys the goods, allowing the consumer the choice to buy or not to buy as the goods are luxury items, that is, items of discretionary expenditure.

IV. “Every tax ought to be so contrived as to both take out and to keep out of the pockets of the people as little as possible over and above what it brings to the public treasury of the state.”

These four maxims of what constitute a good tax have continued to dominate discussion from 1776 when propagated by Smith to the present day. In Australia in one of the

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142 Ibid, p416
143 Ibid
144 Ibid, pp416-7
145 Ibid, p417
146 Ibid
147 From Smith’s essay Of Taxes first published in 1776.
ongoing reviews of taxation the 1970’s the Taxation Review Committee reported in 1976 in the Asprey Report. The Asprey Report determined that the essential criteria for a good taxation system were “efficiency, fairness and simplicity”\textsuperscript{148}. The Asprey concept of efficiency encompassed more than Smith had envisaged. It encompassed getting the taxes out of the pockets of taxpayers at minimal cost and, in addition, ensuring that the imposition of taxes would not have a distorting effect on how the economy applies its productive resources.

Smith identified three major types of taxes, taxes on rents, profits and wages\textsuperscript{149}. Taxes on corporations, in Australia, are taxes on profits. The difficulty with taxing profits, as identified by Smith in 1776, are the main difficulties facing taxing authorities today. They are;

1. the belief that an attempt to tax profits actually results in the tax being paid by the consumer\textsuperscript{150} of the business and
2. the concern that taxing profits will drive the owners of capital to other taxing jurisdictions\textsuperscript{151}.

\section*{John Stuart Mill}

John Stuart Mill while recognising the difficulty of ‘doing perfect justice in taxation’ held that “the difficulty of doing perfect justice is no reason against doing as much as we can.”\textsuperscript{152}

Mill attempted to clarify what he, and Smith, saw as the most important of the four maxims, that is, equality of taxation. Mill considered “equality of taxation… as a maxim of politics, means equality of sacrifice.”\textsuperscript{153} As far as taxing corporations is concerned, the concept of ‘sacrifice’ is a meaningless concept. A corporation has no human needs or desires and therefore cannot suffer sacrifice.

The taxation system that Mill envisaged would, as closely as was practical, result in equality of sacrifice. It had the following features;


\textsuperscript{149} Smith A, \textit{The Wealth of Nations: Book V}, as above, p415

\textsuperscript{150} Ibid, p446

\textsuperscript{151} Ibid, p442


\textsuperscript{153} Mill JS, \textit{Principles of Political Economy}, as above, p804
1. Taxation on wages from personal exertion would include a tax-free threshold so that the necessities of life would remain untaxed and a fixed proportion of wages would be taxed above the tax-free threshold.\(^{154}\)

2. Indirect taxes should be levied on indulgences so that people who can afford them contribute a portion of monies spent on indulgences to the state. In modern terms this would mean limiting the GST to indulgences such as legal (non medically prescribed) drugs, gambling, private transport etc. Essentials, such as food, housing, health, education and basic clothing would be exempted.

Mill rationalises this tax on all people, rich or poor, by the following:

“The immunity extended to the income required for necessaries, should depend on its actually being expended for that purpose; and the poor who, not having more than enough for necessaries, should like other people contribute their quota out of indulgences to the expenses of the state.”\(^{155}\)

Mill also proposed that indirect taxes should be levied on only a few articles so that the burden of collecting the tax is smaller making the tax as efficient as possible\(^{156}\) as opposed to levying indirect taxes on a larger range of items.

3. In order to mitigate inequalities of wealth and therefore opportunity, fortunes, which are inherited, should be subject to progressive taxation.\(^{157}\)

4. Incomes that are unearned, that is, permanent incomes of some kind, such as rent or annuities, should be taxed at a higher rate than incomes from personal exertion. Mill recognised that people who earned income from personal exertion had to provide for their old age. These people, he argued, should have tax remitted on all income applied to saving for their old age.\(^{158}\)

5. A progressive tax should be levied on incomes that increase “without any exertion or sacrifice on the part of the owners”.\(^{159}\) Mills saw this tax as “not properly taking

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\(^{154}\) Ibid, p806

\(^{155}\) Ibid, p807


\(^{157}\) Ibid, p809

\(^{158}\) Ibid, pp813 and 829 (a forerunner of the taxation exemptions for superannuation funds.)

\(^{159}\) Ibid, p817
anything from anybody; it would merely be applying an accession of wealth, created by circumstances, to the benefit of society, instead of allowing it to become an unearned appendage to the riches of a particular class.”  

6. Land tax, which Mill regarded more properly as a “rent-charge in favour of the public; a portion of the rent, reserved from the beginning by the state, which has never belonged to or formed part of the income of the landlords”.

The taxation system envisaged by Mill provides for:

- equality of sacrifice
- income required for the necessities of life to be exempt from taxation
- measures that mitigate the effects of entrenched wealth
- measures that recognise the disadvantage of income from personal exertion compared with permanent income (that is, without personal exertion)

JS Mill was the first influential writer, in English, to consider taxation comprehensively. He incorporated the work of earlier classical liberals Adam Smith and Jeremy Bentham. He considered the different types of taxes available to government, direct and indirect taxes and was the first to consider the different types of taxpayers. That is, Mill distinguished between wage earners, owners of capital and business incomes.

Companies were not influential in Mill’s day and therefore his discussion of the difficulty in taxing business income forms the basis of this thesis’ discussion of the difficulties in taxing companies. Mill’s work is relevant today because he attempted to assess the fairness of taxes between taxpayers and to pragmatically assess the ability of governments to effectively and fairly levy taxes.

The problems of attempting to tax business profits identified by JS Mill were that such taxation would:

1. Diminish the return on capital enjoyed by capitalists and therefore be “a check to further accumulation”,
2. Cause capital to be sent abroad,
3. Cause profits to be “wasted in unprofitable speculations”.

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160 Ibid, p818
161 Ibid, p820 (Mill saw land tax merely “as a mode of levying from the landlords the equivalent of what is taken from other classes” by the privatisation of former feudal lands)
162 Mill JS quoted in O’Brien D P (Ed), *The History of Taxation*, as above, p305
163 Ibid
4. Cause businesses to, after a time, move the burden of taxation “upon the labourer or the landlord”\textsuperscript{165} leading to
5. The existing capital of the country being diminished\textsuperscript{166}.

All of the above difficulties of taxing profits, identified by Mill, are the same difficulties that face our society today when attempting to tax companies. Also, all the arguments raised by Mill are the same arguments raised by businesses whenever an increase in business taxes is proposed in our contemporary society.

Mill did however advance a possible benefit of taxing businesses, that is,

The curtailment of profit, and the consequent increased difficulty in making a fortune or obtaining a subsistence by the employment of capital, may act as a stimulus to inventions, and to the use of them when made. If improvements in production are much accelerated, and if these improvements cheapen, directly or indirectly, the things habitually consumed by the labourer, profits may rise, and rise sufficiently to make up for all that is taken from them by the tax.\textsuperscript{167}

Mill recognised that income tax could be fairly levied on “rents, salaries, annuities and all fixed incomes,”\textsuperscript{168} because they “can be exactly ascertained.”\textsuperscript{169} On the other hand he recognised that “the variable gains of professions, and still more the profits of business,”\textsuperscript{170} are difficult to ascertain by the taxpayer, their ascertainment is reliant on the honesty of the taxpayer and “can still less be estimated with any approach to fairness by a tax-collector.”\textsuperscript{171}

Mill concluded that business taxes therefore,

on whatever principles of equality it may be imposed, is in practice unequal in one of the worst ways, falling heaviest on the most conscientious. The unscrupulous succeed in evading a great proportion of what they should pay; even persons of integrity in their ordinary transactions are tempted to palter with their consciences\textsuperscript{172}.

\begin{flushright}
\footnotesize\textsuperscript{164} Ibid  \\
\footnotesize\textsuperscript{165} Ibid, p306  \\
\footnotesize\textsuperscript{166} Ibid, p305  \\
\footnotesize\textsuperscript{167} Ibid, p304  \\
\footnotesize\textsuperscript{168} Ibid, p311  \\
\footnotesize\textsuperscript{169} Ibid  \\
\footnotesize\textsuperscript{170} Ibid  \\
\footnotesize\textsuperscript{171} Ibid  \\
\footnotesize\textsuperscript{172} Ibid
\end{flushright}
Because of the inability of taxing authorities to fairly levy taxes on business incomes Mill ultimately concludes that any form of income tax even though “the most just of all modes of raising a revenue is in effect more unjust than many others which are *prima facie* more objectionable.”\(^{173}\) He went on to advocate that income taxes only be raised in the case of “great national emergencies”\(^{174}\).

The influence of Mill’s taxation philosophy can be clearly seen in early Australian taxation history. All taxes collected in the Colony of New South Wales up until 1856 were customs duties, mainly on spirits and tobacco, and excise duties on spirits\(^ {175}\). In other words, taxes on luxury items as proposed by Mill. Income taxes were imposed by the Commonwealth government, for the first time, in 1916 during World War 1, to fund Australia’s involvement in the war,\(^{176}\) another example of Mill’s conclusion, that income taxes only be raised in the case of National emergencies.

**Social Liberal views on Taxation**

**John Maynard Keynes**

Social liberals, unlike the classical liberals, do not believe that the unfettered operation of markets (especially unfettered by the impost of taxation) will best satisfy the needs of society. Social liberals, in the words of JK Galbraith, a twentieth century social liberal, recognise that “there are some things the market system does not do well or sometimes even badly.”\(^{177}\) Social liberals recognise that redressing the negative impact of market failings is the responsibility of the state.

JM Keynes, in the *General Theory of Employment, Interest and Money*\(^ {178}\) in 1935 responded to market failure of the great depression. Keynes saw the market failure of the time as

> The outstanding faults of the economic society in which we live are the failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes.\(^ {179}\)

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\(^{173}\) Ibid, p312  
\(^{174}\) Ibid  
\(^{179}\) Ibid, p372
Social liberals do support the operation of free markets, and a market economy, however they recognise that the market is not perfect and requires government intervention to correct the faults of the market. For example, when discussing the disparities of wealth that arise from the operation of unfettered free markets and the need for intervention in that market, Keynes states:

For my own part, I believe that there is a social and psychological justification for significant inequalities of incomes and wealth, but not for such large disparities as exist today. There are valuable human activities which require the motive of money-making and the environment of private wealth-ownership for their full fruition.  

Here Keynes is speaking, in a mildly qualified way, in support of free markets. He goes on to recognise the problems of an unfettered market, and the solution he proposes is that:

It may still be wise or prudent statesmanship to allow the game *(the game of capitalism)* to be played, subject to rules and limitations, so long as the average man, or even a significant section of the community, is in fact strongly addicted to the money-making passion.

Keynes believed that the faults in the operation of the free market could be ameliorated by taxation. In his work he did not distinguish between corporate, business and personal taxes. Nor did he consider the merits of direct and indirect taxes. Keynes’ work was a work of macroeconomics, not concerned with types of taxes, but the overall effect on an economy of tax collections. Keynes’ interest in taxation was the effect that taxation had on the propensity to consume and thus on the rate of employment. The theory was written in the 1930’s during the great depression and Keynes was exploring why the solutions to unemployment were not to be found in the theories of classical economists. Keynes’ conclusion on taxation was, therefore, written in these terms. Keynes concluded that taxes “used as a deliberate instrument for the more equal distribution of incomes, its effect in increasing the propensity to consume is, of course, all the greater.”

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180 Ibid, p374
181 Ibid
182 Ibid, p372
183 Ibid, p3 Keynes described the classical economists as “the followers of Ricardo, …, including (for example) JS Mill, Marshall, Edgeworth and Prof. Pigou.”
184 Ibid, p95
Keynes concluded that if governments used taxation revenues for the “discharge of debt” this represents corporate saving and would therefore reduce the propensity to consume.\textsuperscript{185}

In essence Keynes’ view therefore was that a ‘good’ tax was one where the revenue raised, was used by governments to increase the propensity to consume and a ‘bad’ tax was one used by governments to reduce the propensity to consume.

**The Welfare State**

Social liberal taxation theory make the development of a welfare state possible. The welfare state is often, in political commentary, associated with the rise of Keynesian economics after the Second World War. According to the Australian political economist, Frank Stillwell, the foundations of the welfare state were laid “during the late nineteenth century in Germany and the UK.”\textsuperscript{186} An example of a prominent economist writing in the early twentieth century was John Hobson (1858-1940)\textsuperscript{187}. Hobson is considered one of the founders of the British welfare state. “Hobson believed that government action could end poverty, unemployment, and insecurity, and could establish a society where happiness prevailed.”\textsuperscript{188} Stillwell believes that this kind of social liberal vision “was a foundation on which practical reformers such as Britain’s Lord Beveridge would later build, establishing the welfare state in practice by extending the provision of social security, pensions, unemployment insurance, public education and public health facilities.”\textsuperscript{189}

In Australia, the political party that identifies itself as the social liberal party is the Australian Labor Party (‘ALP’). A former leader of the ALP, Mark Latham, writing a manifesto of the ALP in 1998 called the work *Civilising Global Capital*\textsuperscript{190}, describing the function of social liberals, as he saw them, in the title. Latham saw the job of the State as

> The task of sustaining those things the market was unable to provide citizens in a civilised society.\textsuperscript{191}

Latham recognised that as the expectations of society changed in what was considered a civilised society, so too should the job of government change to ensure that those

\begin{itemize}
\item \textsuperscript{185} Ibid
\item \textsuperscript{186} Stilwell F, *Political Economy: The Contest of Economic Ideas*, as above, p239
\item \textsuperscript{187} Ibid, p240
\item \textsuperscript{188} Ibid, Stillwell is quoting the economist, Daniel Fusfeld.
\item \textsuperscript{189} Ibid
\item \textsuperscript{191} Ibid, p7
\end{itemize}
expectations were met. ALP policy in the late nineteenth century was to “direct government intervention in the production process to guarantee the strength of trade unionism, decent wages and conditions, and a reasonable supply of blue collar jobs.” Government policy to meet those expectations included the imposition of tariff protection for locally produced goods, centralised wage fixing and the white Australia policy implemented to defend Australian “workers against an inflow of low wage Asian and Islander labour.” ALP policy in the 1970’s was directed to establishing “a social democratic program concerned with the rights of citizens: land rights for Aborigines, equal pay for women, racially tolerant migration policies and the universal provision of basic community services … issues of distribution and redistribution were paramount.” Latham continues,

In this fashion, Australian social democracy aligned itself with the Keynesian certainties of a closed economic model – that is, the use of tax policies, transfer payments and social expenditures which could, with precision, mould the distributional features of social opportunity.

Tax assumes greater importance as governments around the world have given up the policy options of tariffs, currency regulation, bank regulation etc.

John Rawls

John Rawls, a philosopher writing in the early 1970’s saw a fair society in terms of distributive justice. Rawls, using a form of social contract argument, developed two principles of justice. Rawls’ social contract was that “free and rational persons concerned to further their own interests would accept an initial position of equality as defining the terms of their association.”

Rawls’ first principle of justice “merely spells out the classical liberal idea of liberty as an absence of political and social interference in individual action.” Rawls’ second principle of justice “spells out a strong commitment to equality of opportunity … with support for positive discrimination.” Rawls recognised that his commitment to positive discrimination

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192 Ibid, p5
193 Ibid
194 Ibid, pp6-7
195 Ibid, p7
199 Ibid
“depends on the background institutions and how they allocate total income, wages and other income plus transfers.” Rawls reconciled his apparently contradictory belief in free markets and in the need for regulation by stating that “once a suitable minimum is provided by transfers, it may be perfectly fair that the rest of total income be settled by the price system, assuming that it is moderately efficient and free from monopolistic restrictions and unreasonable externalities have been eliminated.”

Rawls believed that only taxation would be able to achieve both his principles of justice. He held that the classical liberal ideal of liberty was threatened “when inequalities of wealth exceed a certain limit; and political liberty likewise tends to lose its value, and representative government to become such in appearance only.” In order to preserve the classical liberal ideal Rawls proposed inheritance and gift taxes and adjustments in property rights, “not to raise revenue but gradually and continually to correct the distribution of wealth and to prevent concentrations of power detrimental to the fair value of political liberty and fair equality of opportunity.”

Rawls’ second principle of justice, equality of opportunity, requires taxation in order to raise revenue that will provide “for the public good and make the transfer payments necessary.” In order that “the burden of taxation be justly shared” Rawls proposed a proportional expenditure tax, which contained exemptions for dependents as he thought it “preferable to an income tax (of any kind) at the level of commonsense precepts of justice, since it imposes a levy according to how much a person takes out of the common store of goods and not according to how much he contributes (assuming here that income is fairly earned).” Rawls preferred expenditure taxes because he believed that they would be efficient because they did not interfere with incentives. Rawls did not exclude progressive income taxes though he appeared to approve of them only in the last resort, stating “given the injustice of existing institutions, even steeply progressive income taxes are not justified when all things are considered.”

Rawls argues the case for taxation assuming that “the aim of the branches of government is to establish a democratic regime in which land and capital are widely though not presumably

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200 Rawls J, A Theory of Justice, as above, p277
201 Ibid
202 Ibid, p278
203 Ibid, p278
204 Ibid, p277
205 Ibid
206 Ibid
207 Ibid, p279

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equally held.” In other words Rawls assumed a democratic capitalist society. However, Rawls also acknowledged “it is clear that, in theory anyway, a liberal socialist regime can also answer to the two principles of justice”\(^{208}\) if collective decisions are made democratically, and that his “theory of justice does not by itself favour either form of regime.”\(^{209}\)

**Amartya Sen**

Amartya Sen, a political economist and winner of a Nobel Prize in economics\(^ {210}\), considers John Rawls’ work on ‘justice as fairness’ and arrives at a theory of justice that includes “an adequate understanding of the demands of global justice.”\(^ {211}\) Sen holds that Rawls’ contract theory of fairness allows for “substantial room for ambivalence as to who the parties are who are assumed to be undertaking this contract. Are they all the people in the world – is it a global social contract?”\(^ {212}\) Even though Rawls made it clear that his device was intended to be applied to “each nation – each people – taken separately”\(^ {213}\) it could also be applied to “all people everywhere taken together … seen without distinction of nationality and other classifications.”\(^ {214}\) Sen called these alternatives National Particularism and Grand Universalism.

Sen believed that both these positions were inadequate: National Particularism because it fails to recognise global relations between peoples and Grand Universalism because it fails to recognise the plurality of relations between people and peoples that “are based on classifications other than (Sen’s emphasis) those of nationality and political unit, such as class, gender or social convictions”.\(^ {215}\) Sen proposed a third way, “with an adequate recognition of the plurality of relations involved across the globe.”\(^ {216}\)

Plurality of relations requires recognition of “different groups and different associations, with their respective delineations of ‘borders’.”\(^ {217}\) Sen believes the contract theory of Rawls needs to include contracts between people that recognise their formal and informal loyalties,

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\(^{208}\) Ibid, p280

\(^{209}\) Ibid


\(^{212}\) Ibid, p38

\(^{213}\) Ibid

\(^{214}\) Ibid, p39

\(^{215}\) Ibid, p41

\(^{216}\) Ibid, pp39, 40

\(^{217}\) Ibid, p47
for example a female doctor will have loyalties to her profession and to feminism. National and transnational loyalties also need recognition. The female doctor, for example, will have loyalties toward her fellow citizens and her national professional code of conduct. She will also have loyalties to doctors and women from other countries.

Sen concludes that the “co-existence of many affiliations and diverse identities is a central feature of the world in which we live and cannot be ignored in exploring the demands of global justice.”

### Neoliberal views on Taxation

**F A von Hayek**

F A von Hayek, an economist turned “philosopher of freedom”\(^{219}\), was influential in the late 1950’s to 1970’s and influenced the writing and ideas of Nozick considered later. But more importantly for tax policy Hayek also influenced political thought and policy making. Hayek was a founding member of the right wing think tank, the Mont Perelin Society. Milton Friedman was also a member of this think tank. Stilwell, commenting on these think tanks states, that

Powerful institutions of corporate capital fund other organisations to produce information and promote values conducive to their interests. Often nominally established as research centres, these think tanks are usually directly concerned with propaganda. Not much thinking necessarily occurs. Their typical *modus operandum* is the dissemination of more or less subtle pro-business information and more or less blatant free-market ideology through schools and the media, and the direct lobbying of decision-makers in government and other institutions. They make common cause in this endeavour with right-wing economists, including some of quite professional standing.\(^{220}\)

The impact of these think tanks on policy making is international in scope with both policy makers and the general population. Stilwell continues

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\(^{218}\) Ibid, p50  
These think tanks provided means by which the views of economists such as Milton Friedman and Frederick von Hayek would have a wider influence in society. Their impact on politicians is now legendary, former British prime minister Margaret Thatcher, in particular, being greatly influenced by their work. It is little exaggeration to say that therein lay much of the momentum for the neoliberal ascendancy in matters of economic and social policy.\textsuperscript{221}

In his three-volume work, \textit{Law, Legislation and Liberty}, Hayek addresses what he describes as the “new ‘social’ religion”\textsuperscript{222}, that is, the notion of social or distributive justice. Hayek was “deeply opposed to state interventionist theories, such as those of John Maynard Keynes, which rose to prominence in the 1930s in response to the Great Depression”\textsuperscript{223}, that is, in response to social liberalism.

Hayek recognises that there are many definitions of social justice and he adopts what he holds to be the most common idea of social justice, which “require(s) equal shares for all in so far as special considerations do not demand a departure from this principle.”\textsuperscript{224} Hayek believes that the coercion that would be required to force individuals to achieve a just distribution of goods is in itself unjust. Hayek acknowledges that the manner in which the benefits and burdens are apportioned by the market mechanism would in many instances have to be regarded as very unjust \textit{if} (Hayek’s emphasis) it were the result of a deliberate allocation to particular people. But this is not the case. Those shares are the outcome of a process the effect of which on particular people was neither intended nor foreseen by anyone when the institutions first appeared – institutions which were then permitted to continue because it was found that they improve for all or most the prospect of having their needs satisfied. To demand justice from such a process is clearly absurd, and to single out some peoples in such a society as entitled to a particular share evidently unjust.\textsuperscript{225}

Hayek does not recognise that in the past, other systems of organising society also satisfied the needs of all or most people: systems such as slavery and feudalism. He seems to be

\textsuperscript{221} Ibid
\textsuperscript{223} Harvey D, \textit{A Brief History of Neoliberalism}, published by Oxford University Press, United States, 2007, pp20-21
\textsuperscript{224} Hayek F A, \textit{Law, Legislation and Liberty}, as above, p64
\textsuperscript{225} Ibid, pp64, 65
saying that because the market is impartial and mechanistic in its operation it cannot be unjust, that is, the different outcomes of the market mechanism while unequal can’t be considered unjust. Hayek’s conclusion is that to interfere with the operation of the market would be unjust. Hayek does not explain how interfering with something that is impartial and mechanistic could be ‘unjust’. Hayek identifies the main danger of interfering with the market as “full-fledged socialism” which he equates with totalitarianism and a total lack of individual freedom.

Hayek holds that

the near universal acceptance of a belief (in social justice) does not prove that it is valid or even meaningful any more than the general belief in witches or ghosts proved the validity of these concepts. What we have to deal with in the case of ‘social justice’ is simply a quasi-religious superstition of the kind which we should respectfully leave in peace so long as it makes those happy who hold it, but which we must fight when it becomes the pretext of coercing other men. And the prevailing belief in ‘social justice’ is at present probably the gravest threat to most other values of a free civilization.

He continues

But, like most attempts to pursue an unattainable goal, the striving for it (social justice) will also produce undesirable consequences, and in particular lead to the destruction of the indispensable environment in which the traditional moral values alone can flourish, namely personal freedom.

The only moral value recognised by Hayek is personal freedom, described as ‘the traditional moral value’. But he does not state where this traditional moral value was a tradition. The concept of personal freedom as described by Hayek appears to be a relatively recent construct. In Western society the traditional moral value was adherence to the Judeo/Christian values of obedience to one God and the Ten Commandments.

The role of government in Hayek’s ideal world would be limited to “maintaining law and order and providing for certain collective needs which the market could not satisfy.”

Hayek’s only concession to any notion of social or distributive justice is recognition of the

226 Ibid, p64
227 Ibid, p82
importance of equality of opportunity. For Hayek, equality of opportunity is to be provided by “the government providing on an equal basis the means for the schooling of minors who are not yet fully responsible citizens, even though there are grave doubts whether we ought to allow governments to administer them.”\textsuperscript{228} Hayek does not tell us what the grave doubts are. Hayek also acknowledges that providing education would “still be very far from creating real equality of opportunity, even for persons possessing the same abilities.”\textsuperscript{229} Hayek concludes

Attractive as the phrase of equality of opportunity at first sounds, once the idea is extended beyond the facilities which for other reasons have to be provided by government, it becomes a wholly illusory ideal, and any attempt concretely to realise it apt to produce a nightmare.\textsuperscript{230}

The role of government should not be to interfere in the operation of “a genuine market order”\textsuperscript{231} and any government attempting to interfere with market order would lead to totalitarianism\textsuperscript{232}. Hayek states this danger in the strongest terms stating, “a claim for equality of material position can be met only by a government with totalitarian powers.”\textsuperscript{233}

Hayek cannot envisage any form of democratic decision-making that would allow for a redistribution of wealth. He believes any attempts at interference with the market can lead only to socialism and totalitarianism. Yet from the 1940’s to the 1970’s western economies flourished with governments that were democratic, allowed for private ownership of production and promoted the welfare state. During this period there did not appear to be any danger of these economies becoming either totalitarian or socialist.

The neoliberal ideology of Hayek and his successors, such as Milton Friedman, has according to Stilwell “concurrently undermined the perceived legitimacy of this substantial (the social welfare) role for the state. Governments influenced by neoliberal ideology have sought to cut back welfare state provisions.”\textsuperscript{234} As Self puts it,

When Hayek published \textit{The Road to Serfdom} in 1944, he appeared to be preaching to a lost cause, made no better by his awesome warnings about tyranny to the people

\textsuperscript{228} Ibid, p84
\textsuperscript{229} Ibid
\textsuperscript{230} Ibid, p85
\textsuperscript{231} Ibid, p81
\textsuperscript{232} Ibid, p83
\textsuperscript{233} Ibid
\textsuperscript{234} Stilwell F, \textit{Political Economy: The Contest of Economic Ideas}, as above, p241
of a mature democracy. Fifty years later his support for ‘free markets’ and ‘limited government’ has become the new political orthodoxy.\(^{235}\)

Harvey believes that the ascendancy of neoliberal thought in politics and government policies from the 1970’s onwards was influenced by the award of a Nobel Prize in economics to Hayek in 1974 and Friedman in 1976.\(^{236}\) Harvey believes that these awards gave neoliberal theory “academic respectability”\(^{237}\) even though,

This particular prize, though it assumed the aura of Nobel, had nothing to do with the other prizes and was under the tight control of Sweden’s banking elite. Neoliberal theory, particularly in its monetarist guise, began to exert practical influence in a variety of policy fields.\(^{238}\)

Robert Nozick attempted to provide the theoretical and philosophical basis for neoliberal theory as a theory that provided ‘justice’. How neoliberal theory then influenced the development of taxation policy can be seen by the taxation policy prescriptions of Milton Friedman, discussed below.

**Robert Nozick**

Robert Nozick’s major work, *Anarchy, State and Utopia*\(^{239}\), is essentially, “a defence of libertarian capitalism.”\(^{240}\) Nozick formulated the ‘entitlement theory’ to explain “justice in holdings”\(^{241}\), that is, justice in people having different levels of private property. Nozick stated that

If the world were wholly just, the following inductive definition would exhaustively cover the subject of justice in holdings.

1. A person who acquires a holding in accordance with the principle of justice in acquisition is entitled to that holding.
2. A person who acquires a holding in accordance with the principle of justice in transfer, from someone else entitled to that holding, is entitled to that holding.
3. No one is entitled to a holding except by (repeated) applications of 1 and 2.

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\(^{235}\) Self P, *Rolling Back the Market: Economic Dogma and Political Choice*, as above, p40  
\(^{236}\) Harvey D, *A Brief History of Neoliberalism*, as above, p22  
\(^{237}\) Ibid  
\(^{238}\) Ibid  
\(^{241}\) Nozick R, *Anarchy, State and Utopia*, as above, p150
In Nozick’s utopian world justice in private ownership of property would constitute a ‘world wholly just’. Nozick recognises no other justice, for example, his concept of justice sees all contracts of exchange to be just if freely made. Nozick’s maxim expressing this concept is

From each as they chose, to each as they are chosen.  

Nozick cannot conceive that any contracts made in his free society would not be freely made. Nozick’s theory recognises no contractual injustices that could arise from the use of an imbalance of power between the contracting parties. Nozick does not even recognise that imbalances of wealth could lead to imbalances of power. Nozick recognises that while there may have been injustices in the initial acquisition of holdings he does not provide a way of identifying or rectifying any injustices that occurred in the initial acquisition of holdings. In essence Nozick’s theory of entitlement simplistically equates justice with legality.

It follows from Nozick’s theory of entitlement that all wealth legally acquired was justly acquired, therefore any attempts by government to tax wealth in order to redistribute wealth is unjustified. Nozick holds that “(t)axation of earnings from labor is on a par with forced labor.” Nozick extends his argument against taxation to “include interest, entrepreneurial profit and so on”, calling the taxation of profits “seizure of profits”.

Nozick makes absolutely no mention of companies in his theory. His theory of entitlement considers only the entitlement of people. His view on taxation only considers the taxation of peoples’ labour, interest or profits they may have earned.

Nozick’s theory of justice is a very thin theory; it equates liberty as the right to own property, and the right to own property as liberty. Nozick fails to recognise that “large-scale property accumulation has negative effects on liberty.”

Nozick’s world not only excludes the ever-growing role of the state within contemporary capitalism; it is also radically pre-sociological, without social

\[242\] Ibid, p160
\[243\] Mann S, Business, Ethics and Economics, as above, p79
\[244\] Nozick R, Anarchy, State and Utopia, as above, p169
\[245\] Ibid, p170
\[246\] Ibid, p172
\[247\] Freeman M D A, Lloyd’s Introduction to Jurisprudence, as above, pp538, 539
\[248\] Ibid, p539
structure, or racial or cultural determinants of, and constraints upon, the voluntary acts and exchanges of its component individuals.²⁴⁹

Freeman identifies the above criticism as the central flaw in Nozick’s theory²⁵⁰.

Economists routinely set up economic models which depict utopian worlds of supply and demand and of perfectly informed and rational decision-makers: decision-makers whose only roles are consumption and the provision of labour. The economists ignore the reality of society as identified by Marx in *The Communist Manifesto* that;

> All property relations in the past have continually been subject to historical change consequent upon the change in historical conditions.

> The French Revolution, for example, abolished feudal property in favour of bourgeois property.²⁵¹

Not only does Nozick fail to recognise that ‘large-scale property accumulation has negative effects on liberty’ he also fails to recognise that property relations have been in the words of Marx established by revolution. Marx is talking about peasants ‘getting’ land from the feudal lords and not equating that act with theft. However, I would use blunter language and state that property relations have, largely, been established by theft. A white person living in Australia cannot fail to recognise that all freehold property rights in Australia are grounded in the theft of the land from the original inhabitants. The Aboriginal belief is that the land owns them, not that people own the land.

Marx continues,

> But modern bourgeois private property is the final and most complete expression of the system of producing and appropriating products, that is based on class antagonisms, on the exploitation of the many by the few.²⁵²

Nozick, in failing to recognise ‘constraints upon the voluntary acts and exchanges of its component individuals’ fails to recognise that most people do not engage in ‘free choice’. Most peoples’ choices are constrained by their absolute lack of meaningful choice because

²⁴⁹ Ibid, Freeman is quoting S Lukes.
²⁵⁰ Ibid
²⁵² Ibid
most people do not wield the power of production and of appropriating products. Most people only have the limited power of their labour supply. The choice for most people is limited to withholding labour and living on benefits or charity or accepting whatever job is offered. Nozick’s maxim of ‘from each as they chose, to each as they are chosen’ is thus a nonsense. The Marx maxim “from each according to his capacity, to each according to his need” has been appropriated by Nozick and turned into nonsense.

Milton Friedman

In 1981 Milton Friedman gave a paper in Sydney, Australia called *Taxation Inflation and the role of Government*. Friedman wrote from the point of view that the rapid and dynamic growth experienced in western economies from 1950 to 1970 was not as a result of increased government intervention but that

> What happened in many of these countries during that period was that you were having rapid growth in national incomes, output and employment and you were therefore able to afford to waste more of your substance on governmental activities than otherwise you would have been able to.

Friedman saw ‘true’ taxation as “what government spends, plus the additional cost government imposes on the people in the course of getting the funds to spend.” He identified the components of taxation as being:

- Actual direct and indirect taxes paid by people
- Government borrowings which Friedman saw as a “hidden tax on the wealth of the country” and a “claim on future wealth”
- Government creation of money which Friedman believed to be the sole source of inflation and therefore another hidden tax
- The cost of preparing tax returns, either the direct cost in paying tax advisors or the opportunity cost of preparing your own return, at no charge to the government.
- The cost of imposing tax regulations on the population

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253 Friedman M, *Taxation Inflation and the role of Government*, published by the Centre For Independent Studies, 1981, Australia
254 Ibid, p23
255 Ibid, p6
256 Ibid, pp6, 7
257 Ibid
258 Ibid
259 Traditional economists hold that inflation is caused by ‘too much money chasing too few goods’. However, with Friedman, I agree that inflation is caused by governments increasing the money supply. However, it is not the only source, the other increasingly powerful source of money is created by private sector borrowing.
• The opportunity cost of “some of our ablest people devoting their talents to the strictly unproductive activities of finding ways in which people can avoid taxes”.

Friedman believed that company taxes were the “most invisible” and therefore, the worst, of taxes. Friedman held invisible taxes to be bad taxes because “those of us who like to have the public aware of what is going on ought to be in favour of having taxes as visible as possible.” Using this logic Friedman held that the “least bad taxes” therefore would be “a straight flat tax on all spending above a minimum charged on everybody” followed by “a similar flat tax rate on all income above a minimum.”

Friedman’s opinion on company taxes was:

One thing we know is that a company can’t pay taxes. Only people can pay taxes. What a company can do is collect taxes. What happens is that a company collects taxes from its stockholders, from its workers and from its customers and turns over the proceeds to the government, but it does so in such a way that the workers and the stockholders and the customers hardly know that they have paid taxes.

Friedman stated that company taxes are actually paid by the shareholders, workers and customers of the company ‘paying’ the tax. At the time Friedman was writing, dividend imputation was not government policy. Since then, Australia, and many western nations have instituted dividend imputation. Dividend imputation relieves shareholders of any tax already paid by the company from which they receive their dividends. In other words, company shareholders do not pay taxes on their company dividends to the extent that the company has paid income tax on profits. This leaves companies, according to Friedman, only able to ‘collect’ taxes from workers and customers.

Most western countries, including Australia, have some sort of minimum wages system to protect employees from exploitative wages. Minimum wages protect employees from any downward pressure on wages that could result from the effect of taxes paid by their employer company. Even if wages were not protected by the existence of minimum wages and they were ‘freely’ negotiated between a company, other employers and their workers,

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260 Friedman M, *Taxation Inflation and the role of Government*, as above, p8
261 Ibid
262 Ibid
263 Ibid, p9. This comment of Friedman’s makes it clear that he considered all taxes to be bad.
264 Ibid
265 Ibid
266 Ibid, p8
the market would ensure that wages were set according to demand and supply of workers. Workers would, therefore, not be paying the company tax.

Again, in Friedman’s competitive free market world, customers are protected from paying the taxes of the companies from which they purchase their goods by the operation of the free market. In the market, competition between companies ensures that the prices paid for goods are regulated by the demand for goods, not how much tax the companies manufacturing the goods pay.

Is Friedman, here, tacitly acknowledging the failure of the free market to set prices for goods by acknowledging that companies can impose their costs, such as taxes, onto customers?

**Post-War Australian Tax Policy**

A brief examination of Australian post World War 2 taxation policy reveals the influence of economic ideology on Australian taxation policy. Prior to World War 2 all Australian states levied income taxes and the Commonwealth had only a residual power to impose income taxes. In 1942 the states agreed that the Commonwealth appropriate the taxing power from the states. Prior to World War 2 taxation policy in Australia was influenced by classical economists such as JS Mill and this was reflected in taxation policy. For example, in all Australian States taxation on wages from personal exertion included a tax free threshold so that the ‘necessities of life’ remained untaxed. Dividends, ‘unearned income’ in JS Mill’s terms, were taxed at a higher rate than incomes from personal exertion\(^\text{267}\) so that people who earned income from personal exertion could provide for times when they could no longer work. All states imposed inheritance taxes in order to ‘mitigate inequalities of wealth and therefore opportunity’.

The expenses of the war meant that the amount of taxation revenue raised more than doubled from pre-war levels. The total taxation revenue as a percentage of GDP went from 15.4% in 1938-39 to 27.8% in 1948-49\(^\text{268}\). This increased level of taxation has remained but was made acceptable to the Australian people immediately post-war by the general acceptance of social liberal ideology.

In the era after World War 2 the major changes to taxation policies in Australia\(^\text{269}\) were;

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\(^{268}\) Australian Bureau of Statistics, *2001 Year Book Australia*, as above, p939

1944 – periodic tax payments through the employer was introduced for wage and salary earners and provisional tax was introduced for non-wage and salary income
1952 – Commonwealth land tax was abolished in favour of the States
1971 – Commonwealth passed payroll tax to the States after they requested access to income tax
1976 – Queensland, New South Wales and Victoria abolished death duties
1978 – The Commonwealth, Tasmania and Western Australia abolished death duties
1979 – South Australia abolished death duties
1981 – Personal income tax indexation abolished
1984 – Medicare levy introduced at 1.5% of income above a minimum threshold
1986 – Capital gains tax and Fringe Benefits tax introduced
1986 – Company tax rate was set at 49% of profits
1987 – Dividend imputation introduced, replacing the ‘classical’ taxation of companies
2000 – 10% GST introduced to replace wholesale sales taxes
2001 – Company tax rate reduced to the present level of 30% of profits

The influence of neoliberal ideology on Australian taxation policy can be seen in the following events:
1. In 1976 a conservative government in Queensland began an Australian ‘race to the bottom’ in death duties by abolishing them. All Australian states quickly followed. As seen earlier, JS Mill proposed the imposition of progressive taxation on inherited fortunes ‘to mitigate inequalities of wealth and therefore opportunity’.
2. The Commonwealth government reduced the top marginal tax rates for high income earners over the past 40 years from almost 70% (in 1965-66) to its current level of 48.5 per cent (including the Medicare levy). This was written in 2003 and since then Australia’s top marginal tax rate has fallen again to 46.5 percent for the tax year 2007-08.
3. The Commonwealth government reduced company tax rates from a high of 49 per cent in 1987 to 30% from 1 July, 2001 to the present day.
4. The Commonwealth government introduced dividend imputation in 1987 and it is still in force.

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270 Income Tax Rates Act (1986), s23
271 Commonwealth of Australia, International Comparison of Australia’s Taxes, published by the Commonwealth of Australia, 3 April 2003, p63
273 Commonwealth of Australia, International Comparison of Australia’s Taxes, as above, p141
5. In 1981 the Commonwealth government abolished personal income tax indexation which in real terms has the effect of reducing the tax free threshold for the necessities of life for low income earners and placing more middle income earners into higher marginal tax brackets.

6. In 2000 targeted wholesales sales taxes, which had in the main been levied on ‘luxuries’ such as alcohol, tobacco, fuel and motor vehicles was replaced by a general GST levied on all goods and services. In other words, a regressive tax was imposed on the Australian people which included the ‘necessities of life’ and which had greatest impact on low income earners.

**Conclusion**

The discussion of an equitable society by the neoliberals and the social liberals includes no discussion of the place of firms, or companies in society and how they should be treated. The equitable society as envisaged by Hayek, Nozick, and Friedman is however, grounded, and supported, by conservative economic theory: economic theory on how markets operate amorally and efficiently, and theories of firms and their place in the market. Economic theory, therefore, explicitly acknowledges the impact of firms on the efficient operations of markets.

The political economist Frank Stilwell acknowledged the important influence of economic theory on the collective decision making involved in policy matters such as taxation thus:

> The way in which these issues have been addressed in economic analysis and policy has been strongly influenced by one particular economic theory – neoclassical economics. This emerged in the late nineteenth century and is still the dominant economic orthodoxy today. It stresses the beneficial effects of competitive markets as a means of allocating economic resources. From the neoclassical viewpoint, the role of government is, at most, that of an adjunct to the ‘free-market’ economy. The underlying view is that the capitalist economy is a stable, self-equilibrating system.\(^{274}\)

Even though these economic theories may be considered to provide unrealistic models of ‘the real world’ they “have a strong influence on economic policies in practice; and they

therefore have an awesome relevance – for better or worse." These economic theories of the firm and of profits are considered in the following chapter.

\[275\] Ibid
Chapter 3 The neoclassical economic and social liberal views of the capital, profits and the firm

Introduction

In Australia, as in most taxing jurisdictions in the world, company profits are subject to income tax. The ethics of taxing company profits has moral dimensions. Firstly, the morality of the provision of human rights and the associated need to fund those rights, to be provided by taxation, as discussed in chapter one. Secondly, the moral significance of profit as being rewards for sacrifice or being a fair and just reward, and how that shapes the approach to taxing it. As will be seen below the moral view of profits taken shapes attitudes and acceptance of how those profits are taxed. The accounting view of profit is that of a relatively simple and value free surplus of revenue over expenditure. The current neoclassical view of profits, that they are ‘just deserts’ leads to the view that profits should not be taxed or only lightly taxed. The social liberal view is of profits as a surplus generated by mixing labour and capital. This surplus “can be distributed in any which way between workers and employers in the form of wages and profits. Who will get what depends on the relative social and institutional power of the two sides.” 276 Social liberals are more likely to see taxation as a means of redressing power imbalances between workers and employers.

Galbraith argued that the essence of the neoclassical economic model of markets firms and profits “is that individuals using income derived… from their own productive activities express their desires by the way they distribute this income for the various goods and services available to them in markets.” 277 Galbraith, as shown below, turns this moral sanction upside down by demonstrating that the profound assumption of neoclassical market theory is not valid and consumers do not control the market. Galbraith argues that firms, operating in increasingly monopolistic markets, control the market.

Neoclassical economic market theory shapes modern political thought and policy making and therefore it is essential that it be understood. Neoliberals subscribe to the central tenets of neoclassical economists who claim to objectively analyse the economy as it actually is, calling their analysis positive economics. 278 They claim that their analysis “renders political,

278 Varoufakis Y, Foundations of Economics: A Beginners Companion, as above, p175
social and ethical aspects irrelevant”279 and attempt to turn economics into a science that therefore can’t be argued with or questioned. Earlier classical liberals Adam Smith and David Ricardo were explicit about their politics and values; and, according to Varoufakis, “it was not until the emergence of neoclassical economics that economists began to pose as scientists above politics and invented the myth of positive economics.”280

This chapter examines neoclassical economic market theory, theory of the firm and of profits in order to understand government policy with respect to the taxation of firms. The social liberal economist who best understood and deconstructed neoliberal theories of the market, firm and profits, was John Kenneth Galbraith in his work *The New Industrial State*281.

The accounting view of profits is considered first because taxes are based on the accounting view of profits. The rates of taxes imposed, the presence or otherwise of dividend imputation and other taxation legislation is however, influenced by neoclassical or social liberal theory and ideology.

**Accounting view of profits**

On 2 May 2007 the EU Taxation Commissioner, Laszlo Kovaks presented a “second Communication on progress towards harmonising national tax systems for companies”282 operating in the EU that was adopted by the Commission of the European Communities.283 This communication expressed the general methodology for determining the tax base of a company as follows;

The initial starting point for determining the tax base of a company may be by reference to the comparison of opening and closing balance sheets or by reference to the profit and loss account of the company.284

This simply states the accounting view of profit as either the change in value of a company between two accounting periods or the surplus of income earned over expenditures between two accounting periods. The change in value of the balance sheets and the surplus of income

279 Ibid, p176
280 Ibid, pp175-176
283 Ibid
284 Commission of the European Communities, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee*, Brussels, 2.5.2007, p9
over expenditure should be the same amount, that is, the profit earned by the company in the accounting period being measured.

The work of the EU in attempting to find a Common Consolidated Corporate Tax Base (‘CCCTB’) is assisted by the work of the International Accounting Standards Board (‘IASB’). The work of the EU in harmonising taxes would not be effective if companies operating in the EU did not report their profits based upon “a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting”\(^\text{285}\). The formal objective of the IASB is restated on its Home Page web site as

> The objective of the IASB is to achieve convergence in the accounting principles that are used by businesses and other organisations for financial reporting around the world. This, in turn, improves the ability of investors, creditors, governments and others to make informed resource allocation and policy decisions.\(^\text{286}\)

Major policy decisions assisted by uniform, enforceable accounting standards are of course necessary in governments setting corporate taxation policy.

The reach of IASB accounting standards extends far beyond the EU. In May 2000 the International Organization of Securities Commissions (‘IOSC’) “formally accepted the IASB’s core (accounting) standards as a basis for cross-border securities listing purposes worldwide.”\(^\text{287}\) By June of 2000 the EU required that all companies listed in the EU would be required to prepare their financial statements using International Accounting Standards promulgated by the IASB. There are still some notable exceptions to the take-up of IASB accounting standards, but even these exceptions acknowledge that corporations seeking to raise capital or do business internationally are preparing their financial statements using IASB accounting standards. For example, in the US stock exchange listing requirements are that companies reconcile certain items such as earnings and shareholder’s equity to national, that is, US Generally Accepted Accounting Principles. The US stock exchange listing authority acknowledges in this rule that most US companies are preparing their financial statements using the accounting rules promulgated by the IASB.


\(^{286}\) Ibid, p.1.02

\(^{287}\) Ibid, p.1.03
A further indication of the reach of IASB accounting standards is in the composition of the Trustees, the governance arm of the IASB. “There are 19 trustees, of whom six should be from North America, six from Europe, four from the Asia/Pacific region, and three from any area, subject to establishing ‘overall geographical balance’.”\(^{288}\)

The very first International Accounting Standard (‘IAS’) called IAS1 is called ‘Presentation of Financial Statements’ and prescribes “the basis for presentation of general purpose financial statements in order to ensure comparability both with the entity’s own financial statements of previous periods and with the financial statements of other entities.”\(^{289}\) In other words, IAS1 aims to provide a comparable, transparent and objective measure of the performance of entities. IAS1 provides that a complete set of financial statements must include the following components;

1. A balance sheet;
2. An income statement;
3. A statement of changes in equity showing either:
   a. All changes in equity, or
   b. Changes in equity other than those arising from transactions with equity holders acting in their capacity as equity holders
4. A cash flow statement, and
5. Notes, comprising a summary of significant accounting policies and other explanatory notes.\(^{290}\)

This is a pragmatic attempt to measure the profits of entities operating in different jurisdictions, different industries, which are differently constituted in a way that is comparable. Accounting standards don’t question that the aim of a firm, entity or company is to make profits. The only purpose is how to account and record those profits. The primary concerns of financial statements are the balance sheet and the income statement as expressed by the EU Taxation Commissioner, Kovaks, above.

Mill’s concerns in 1871 as to the difficulty of actually assessing profits in this sense still resonate, especially with the recent major corporate collapses, Enron et al, where accounting profits had been manipulated. However, the ability to manipulate the accounting profits of major corporations is moderated by the transparency of published accounts prepared in conformity to accounting standards and the requirement that they be audited. The other

\(^{288}\) Ibid, p1.06  
\(^{289}\) Ibid, p3.01  
\(^{290}\) Ibid, p3.04
moderating factor against companies understating their profits is the pressure for dividend returns from shareholders as discussed later.

Neoclassical Economic Market Theory

Neoclassical economists explain the behaviour of consumers and businesses by using models of different market structures. Australian policy makers attempt to predict the impact of their policies, including tax policies, using these neoliberal market models. Australian politicians attempt to gain acceptance for their policy proposals by pointing to economic modelling which purports to demonstrate the effect of their policies ‘on the market’.

The social liberal economist Frank Stilwell has described the four neoclassical market descriptors on the three bases by which they are differentiated. These three bases are;

- the number of sellers and importance of each,
- the nature of products supplied and
- the entry conditions for new firms.  

The four neoclassical market descriptors as described by Stilwell are therefore understood, in neoclassical terms, to be;

1. Perfect competition where there are;
   - a. A large number of sellers, each accounting for a small proportion of the total output of the industry,
   - b. Homogeneous, perfectly substitutable, products supplied and
   - c. No restrictions on the entry of new firms

2. Monopolistic competition where there are;
   - a. Fewer sellers than under perfect competition but the proportion of output supplied by each is still relatively small,
   - b. Broadly substitutable products supplied, differentiated only slightly and
   - c. No restrictions on the entry of new firms

3. Oligopoly where there are;
   - a. A few important sellers accounting for a large proportion of the output,
   - b. The products are differentiated according to brand names and
   - c. There are some restrictions on the entry of new firms

4. Monopoly where there is;
   - a. One seller,

291 Stilwell F, Political Economy: The Contest of Economic Ideas, as above, p176
292 Ibid, p177
b. No directly competitive products and
c. Some restrictions on the entry of new firms.

These market descriptors are in the language of economists and used in most standard economic textbooks. These standard texts also go on to state that whenever sellers charge prices so high that they are able to make an economic profit, (explained later in this chapter), then other “firms are enticed to enter the market.” These other firms bring the prices for the products down so that no economic profits are made and so the free market self-equilibrates back to that of perfect competition. Economists recognise that in some circumstances “there are sunk costs or other barriers to entry, (so) markets will not be contestable, and monopoly profits can persist.” However, even if the barrier to entry is the ‘sunk costs’ that is, large fixed costs to establish the competitive firm, neoliberals hold that, over time, even this barrier is surmountable if the market is allowed to operate freely. Presumably, in a free unregulated monopoly market the monopolist will increase prices to such an extent that a competitor or competitors will be lured into the market by the monopoly profits. Thus the free market self regulates back to maximum efficiency if left alone from interference.

Economic inefficiencies that result from imperfect competition such as oligopolies and monopolies are “restricted output, managerial slack, insufficient attention to research and development, and rent-seeking behaviour.”

Rent-seeking behaviour is when monopolists use their resources and market position to prevent other firms from entering their market. For example, Australia’s major airline, Qantas, used its market dominance to undercut the fares offered by Compass Airlines, a new market entrant and potential competitor which collapsed in 1992 and, an existing competitor, Ansett airlines, which collapsed in 2001. In 2000 another competitor emerged, Virgin Blue, and ever since there has been a price war between Qantas and the new competitor. Qantas even established a low cost airline, Jetstar, to take on the unwelcome competitor.

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295 Ibid, p285
296 Ibid, p289
297 Ibid, p292
Company taxation policy in Australia reflects this neoclassical market view in that it accords all companies formal equality with respect to taxation. All companies, whether they are operating in conditions of perfect competition, monopolistic competition, oligopoly or monopoly pay the same rate of tax on their profits: The corner store, operating in conditions of nearly perfect competition, is paying the same rate of tax as the major supermarket chain operating in an oligopolistic market situation.

**Neoclassical Theory of the Firm**

The neoclassical theory of the firm ... is an elegant edifice. As the core of orthodox economic thinking about economic behaviour it warrants careful consideration. Like the theory of the consumer, it is based on some distinctive assumptions about rationality and the nature of the environment within which economic decisions are made. It presents a general view of firms as instruments for making choices conducive to clearly defined goals. Also, like consumer theory, it seeks to link behavioural postulates, such as the quest for profit maximisation, with empirically measurable constructs, such as supply curves showing how much firms will produce at different market prices.\(^{298}\)

This elegant edifice makes assumptions as to how firms operate in their free markets. All economic decisions made by firms are made to maximise profits, to utilise the demand and supply curves to absolute advantage, that is, to produce goods and services at the point where the marginal revenue of the firm equals the marginal cost of the firm. These assumptions include assumptions about the behaviour of suppliers and consumers. For example, consumers are always informed and make rational decisions that will maximise their utility. Consumers will always buy the cheapest product on the market, thus ensuring that firms compete and produce goods at the lowest possible costs. All these assumptions support the core assumption of neoclassical economists, that is, the market, unimpeded is the most efficient way to satisfy the needs of society, and that what is good for the market is good for society.

The theory of the firm is more than an exercise in geometry though; it also seems to convey a powerful message about the nature of a free-enterprise capitalist economy. It emphasises the relentless pressures for efficiency and the essential subservience of

\(^{298}\) Stilwell F, *Political Economy: The Contest of Economic Ideas*, as above, p175
business interests to those of consumers. As such, it is the basis of a powerful economic ideology.\footnote{Ibid}

Stilwell calls the neoclassical theory of the firm the theory that may recognise the diversity of business types, but which delivers a single theory to cover all those types.\footnote{Ibid, p167}

What are firms? Evidently, business organisations come in many shapes and sizes; some are engaged in agricultural production, some in mining, some in manufacturing, some in finance, and some in the provision of services. Some are big, some small. Some are companies, some partnerships, and some sole traders. Some are transnational corporations, some are corner stores. Neoclassical economics attempts to build a single theory that applies to them all. Alfred Marshall paved the way this with his notion of the ‘representative firm’. Contemporary neoclassical economics textbooks develop this theme by presenting models purporting to show the universal features of business behaviour. This is not to claim that all firms are identical; rather, it is to assert that common principles underlie the differences in scale, organisation and type of activity. It is a bold claim.\footnote{Ibid}

The representative firm was first postulated by Alfred Marshall in his *Principles of Economics*\footnote{Marshall A, *Principles of Economics*, Macmillan and Co., Limited, London, Eighth Edition, 1920} when he was attempting to discover “the causes which govern the supply price of a commodity.”\footnote{Ibid, p317} Marshall postulated that to find the cost of producing a commodity for a given volume of production it would be necessary “to study the expenses of a representative producer for that aggregate volume.”\footnote{Ibid} Marshall recognised that some firms were new producers, some were mature firms, some were large and efficient, some small and efficient. This is a limited view because Marshall doesn’t recognise the existence of inefficient firms. For the purposes of his analysis he needed an average\footnote{Ibid, p318} firm. He defined his average firm as one which has had a fairly long life, and a fair success, which is managed with normal ability, and which has normal access to the economies, external and internal, which belong to that aggregate volume of production; account being taken of the

\begin{footnotes}
\footnotetext[299]{Ibid}
\footnotetext[300]{Ibid, p167}
\footnotetext[301]{Ibid}
\footnotetext[303]{Ibid, p317}
\footnotetext[304]{Ibid}
\footnotetext[305]{Ibid, p318}
\end{footnotes}
class of goods produced, the conditions of marketing them and the economic environment generally.\textsuperscript{306}

This influential idea permeates the study of corporate taxation – the idea that is the basis of formal equality in the taxation of corporations.

The most important maxim of a good taxation system is for taxpayers to be treated fairly. In Australia all firms are taxed under one law, \textit{The Income Tax Assessment Act}, which taxes all companies, public and private, large and small, from those operating in perfect competition to those operating as a monopoly, in exactly the same way. In other words, companies are accorded formal equality before taxation law in Australia.

“In general economic activity can be organised according to two modes, the market and the system of firms: the latter is the antithesis of the former. Following this reasoning, one might expect the theory of the firm to be based on the study of organisational form and power relationships, …”\textsuperscript{307}

However, “the dominant tradition within neoclassical theory has been to treat firms as single decision-making units operating in a market context, atomistic units in an economic environment characterised by equilibrating processes.”\textsuperscript{308}

This is how taxing authorities in Australia treat firms, ‘as atomistic units in an economic environment’. This explains the taxing of firm profits as though firms were individual units rather than, as in most cases, subsidiaries and/or members of groups of firms. Transfer-pricing policies, which attempt to find arms’ length values for inter-firm dealings is a clear example of neoclassical theory of firms being used to tax firms.

The Neoclassical View of Profits

Neoclassical economists hold three views of profits. Firstly, in a perfectly competitive market there are no profits because the return on capital to the capitalist is merely the marginal revenue product of capital determined by the market. This marginal revenue product is the economic rent due to capital, that is, the just deserts for providing capital. Secondly, any profits earned, above the marginal revenue product of capital, is due to the superior capabilities of the capitalist earning those profits. These profits are also, as in the

\textsuperscript{306} Ibid, p317
\textsuperscript{307} Stilwell F, \textit{Political Economy: The Contest of Economic Ideas}, as above, p167
\textsuperscript{308} Ibid, pp167, 168
first case, seen as the just deserts of the capitalist earning them. Thirdly, if there are profits then they have arisen due to the operation of an imperfect market that has allowed an oligarchy or monopoly to have occurred. These monopoly profits will, if the market is left alone, eventually self-equilibrate to zero as capital moves into this market and so gets rid of the market imperfection.

Firstly, no profits

Hunt, quoting the neoclassical economist Clark on the “neoclassical vision of competitive equilibrium” where there are no profits.

Normal prices are no-profit prices. They afford the wages for all the labor that is involved in producing the goods, including the labor of superintending the mills, managing the finances, keeping the accounts, collecting the debts and doing all the work of directing the policy of the business, whether it is owned by the entrepreneur or borrowed from someone else. Beyond this there is no return, if prices stand exactly at their normal rate; and the reason for this is that entrepreneurs compete with each other in selling their goods, and so reduce their prices to the no-net-profit level. 309

Stiglitz and Walsh in their standard text, *Economics* 310 answer the obvious question of “how it can be true that (economic) profits are zero when firms in the real world routinely report making profits?” 311 Their answer is that accountants calculate profits simply as “revenues minus expenditures” 312 while economists regard profits as “revenues minus rents minus economic costs (including opportunity costs of labor and capital)” 313.

The term ‘rents’ here is used, not as the lay person understands rent, but as defined by economists as ‘economic rent’. Stiglitz and Walsh define economic rent as “the difference between the price that is actually paid and the price that would have to be paid in order for the good or service to be produced.” 314 This definition is consistent with the neoclassical

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311 Ibid, p166
312 Ibid, p171
313 Ibid
314 Ibid, p168
concept of ‘profit’, that is, that in a perfectly competitive market no firm can earn profits because competition would drive the purchase price down to the marginal cost of production.

Secondly, profits as rewards for superior capabilities

The neoclassical justification for firms earning this ‘economic rent’ is that they can only earn this rent “to the extent that they are more efficient than other firms.” Stiglitz and Walsh state the proposition thus

We saw earlier that a firm is willing to produce at a price equal to its minimum average cost. Some firms might be more efficient that others, so their average cost curves are lower. Consider a market in which all firms except one have the same average cost curve, and the market price corresponds to the minimum average cost of these firms. The remaining firm is super-efficient, pushing its average costs far below those of other firms. The company would have been willing to produce at a lower price, at its minimum average cost. What it receives in excess of what is required to induce it to enter the market are rents – returns on the firm’s superior capabilities.

This argument epitomises the neoclassical economists’ moral position on profits. Profits are moral because they are a reward for superior efficiency, in other words, profits are a just payment, or just deserts.

Thirdly, profits as the result of an imperfect market

Profits that result from the operation of an imperfect market are known as monopoly profits. Neoclassical economists do not view these profits as normal profits, calling them ‘pure profit’ or ‘monopoly rents’. As explained above, in a perfectly competitive market no firm can earn profits because competition would drive the purchase price down to the marginal cost of production. However, an imperfect market will allow the producer to charge prices at the point where marginal cost equals (in the monopoly situation) or is close to marginal revenue.

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315 Ibid
316 Ibid
Stiglitz explains monopoly profits as “an extra return because it (the monopolist) has been able to reduce its output and increase its price from the level that would have prevailed under competition.”\textsuperscript{317}

Neoclassical economists see profits as a failure of market equilibrium or as a reflection of inefficient markets because only inefficient markets would allow profits in the first place. Neoclassical economists believe that the profit made by the monopolist will “entice other firms to enter the market”\textsuperscript{318} thus eliminating the monopoly profit over time.

Hunt expresses the neoclassical self-equilibrating view of the market as:

Thus, with initial endowments of private property secured as just and natural, equilibrium prices established by a cosmic crier, and mythical entrepreneurs constantly striving for non-existent profits, the invisible hand of exchange maximises every person’s utility as they ubiquitously and universally engage in tens of thousands of marginal utility and price calculations and exchange their goods having less utility per dollar’s value for goods having more utility per dollar’s value. Everyone’s interest is in harmony with every other person’s interest, and each maximises his or her own utility.\textsuperscript{319}

Hunt’s reference to the ‘cosmic crier’ is a reference to neoclassical economists’ theory of general equilibrium. General equilibrium theory allows economists “to evaluate the working of the economy as a whole …a … basis for seeing how all the parts fit together.”\textsuperscript{320}

General equilibrium is said to exist when a set of prices for goods and factors of production equates supply and demand in all markets simultaneously. It is a purely theoretical situation. No neoclassical theorist would claim that the real world ever achieves this state.\textsuperscript{321}

Neoclassical theorists while recognising that general equilibrium is “seldom if ever attained …is a condition to which the economy continuously tends.”\textsuperscript{322}

\textsuperscript{317} Ibid, p265
\textsuperscript{318} Ibid, p274
\textsuperscript{319} Hunt E K, \textit{History of Economic Thought: A Critical Perspective}, as above, p307
\textsuperscript{321} Ibid
\textsuperscript{322} Ibid, p198
From a political economy perspective, what is more important than the technical specifications of general equilibrium theory is the vision it presents of self-regulating market economy. This is its normative application – the basis for the belief that markets are the best means of economic organisation. As such, it has a powerful ideological function supporting laissez-faire principles.  

Partial equilibrium analysis is when one market at a time is analysed ignoring what is going on in other markets. Stiglitz and Walsh advocate the use of partial analysis in circumstances “when more distant general equilibrium effects are likely to be so faint as to be indiscernible”.

**Problems with Profit as a Just Payment**

The neoclassical views of profits as either ‘no profit’ or ‘profits as rewards for superior capabilities’ are both positions that view profits as just payments. The neoclassical view of monopoly profits is that they are created by imperfect markets that will, if left alone, self-equilibrate. In other words, imperfect markets are only temporary and will become perfect over time.

The neoclassical position of profit as a just payment is explained by Varoufakis

> For if it were accepted that labour is a commodity like all others, then all would agree that its value corresponds to the marginal utility it offers its buyer (like all other commodities). And if capital were also thought of as a commodity, then all would agree that its value can be explained with regard to the marginal utility it offers its buyer. Then, by default everyone would agree that in a (competitive) market economy labour and capital, just like all other commodities, receive payments consistent with their marginal productivity.

The punch line of this reasoning then is that it then “takes a tiny step to travel from this conclusion to the belief that, under capitalism, labour and capital receive their just rewards.” All factors of production, labour, capital and physical inputs receive their price

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323 Ibid  
324 Stiglitz JE and Walsh CE, *Economics*, as above, p227  
325 Ibid, p234  
327 Ibid
as set by the competitive market, “there is no exploitation and no extraction by one group of
the products of someone else’s labour or application.”

The rewards for investing capital takes many forms, for example, rent is the reward for
owning property and making it available for use by others, interest the reward for allowing
others the use of your money, profits the rewards for investing in a business and dividends
the rewards for owning shares. Neoclassical theory presents the reward for capital as being
“To each according to the value of the contribution of her physical and human capital”. In
other words dividends are merely a fair reflection of the productivity of capital, a just
payment.

The other neoclassical justifications for rewards for capital are the sacrifice made in
investing, deferred gratification and risk. Shareholders with limited means do sacrifice the
gratification of immediate consumption in order to purchase shares to secure a dividend
income stream and hopefully, increased share value in the future. However, these
shareholders are not the majority of share investors. The vast majority of share wealth is
owned by a tiny minority of wealthy individuals who have sacrificed nothing to enjoy the
benefits of share ownership. It has been estimated that ten per cent of families around the
world own half the worlds’ listed share capital. Even this concentration of share
ownership in relatively few hands is probably a severe underestimate because, “less known
is the fact that by 2000, three people owned more wealth than the total income of the world’s
48 poorest countries.” Shareholder risk is minimised by the fact that limited liability
makes shareholders “effectively immune from all responsibility for corporate misdeeds and
debts beyond the extent of their original investment.”

The neoclassical view that profits are a just reward for the provision of capital has been
refuted by the work of John Kenneth Galbraith and Piero Sraffa. Galbraith used observations
of what was actually occurring in the US economy in the 1960’s and 70’s and coined the
term the planning economy to illustrate the power imbalances that undermine the
neoclassical theory of just exchanges and just profits. Sraffa developed a Pure Production

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328 Ibid, p181
330 Head M and Mann S, Law in perspective: ethics, society and critical thinking, published by UNSW Press, Australia, 2005, p293
332 Mann S, Economics, business ethics and law, published by the Lawbook Co., Australia, 2003, p80
Model, using the same modelling techniques of the neoclassical economists, to demonstrate that profits were a surplus divided between labour and capital on the basis of the economic and political strength of labour and capital.  

**Piero Sraffa**

Neoclassical economists hold that perfectly competitive markets produce no profits because the return on capital to the capitalist is merely the marginal revenue product of capital determined by the market, in other words, rate of profit depends on the quantity of capital. The “neoclassical theory of income distribution is that factors get paid in accordance with their marginal contribution to output in the concept of diminishing marginal returns. This means that as the supply of a factor increases, its return should fall.”  

Keen identifies the difficulty of treating capital as an homogenous factor of production:

> It is not easy to see how one can add units of capital together. Workers can be aggregated by adding up the number of hours they work – after notionally standardising for different levels of productivity by multiplying the hours of skilled labour by some amount to reflect higher productivity. Land can be aggregated by adding up acres – and again by adjusting numerically for varying degrees of fertility. But machines have no apparent common property apart from price. This is in fact how economic theory aggregates capital, but this involves an obvious circularity, because the price of a machine reflects the profit expected from it, yet the rate of profit is the ratio of profit to price.

Sraffa recognising this circularity “was to eschew the initial aggregation of capital, and to say, in place of ‘factors of production to produce goods’, that ‘goods produce goods’ – in concert with labour. Sraffa then used this ‘assumption free’ model to show that the (neoclassical) theories of price and of income distribution were invalid.”

The essential point in his (Sraffa’s) analysis was that capital does not exist as an easily identifiable entity, yet such an existence is necessary for the simple parable that profit represents the marginal productivity of capital to be true. He made this

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334 Ibid, p141  
335 Ibid  
336 Ibid, p137
point by constructing a series of models that directly confronted the true complexity of a system of commodity production.\textsuperscript{337}

“Sraffa’s purpose was to critique economics on its own terms.”\textsuperscript{338} Sraffa therefore, constructed his models, increasing the complexity with each model, assuming an economy in equilibrium, the same assumption made by conventional economists. Sraffa constructed three models, of increasing complexity;
1. Production with no surplus,
2. Production with a surplus and
3. Production with a surplus and explicit labour

1. Production with no surplus
In this model

The economy was just able to reproduce itself, and in which there was no ‘fixed capital’ – instead, all inputs were ‘circulating capital’ which were used up in each round of production. In this economy, the output of each industry was just sufficient to supply the demand for its output by itself and the other industries. Labour was not explicitly treated, but it was feasible to envisage that part of the inputs to an industry represented workers receiving a subsistence wage. Sraffa posed the question of what would determine prices in this hypothetical economy, and the answer was not ‘demand and supply’, but the ‘conditions of production’: each sector’s price had to enable it to just purchase its inputs.\textsuperscript{339}

By the use of this model Sraffa refuted one of classical economists’ fundamental tenets that prices of products are determined by supply and demand, rather they are determined by the conditions of production, that is, “the only prices that work for this economy are those that enable each sector to buy its inputs.”\textsuperscript{340}

Sraffa is not actually denying that changing conditions of supply and demand can influence prices. But he is arguing that a genuine ‘equilibrium’ has to have a material foundation, in the ongoing reproduction of the actual physical means of production.

\textsuperscript{337} Ibid
\textsuperscript{338} Ibid
\textsuperscript{339} Ibid, p138
\textsuperscript{340} Ibid, p139
2. Production with a surplus

Sraffa’s next model adds the ‘realistic’ assumption that at least one sector in the economy produces a surplus.

This step closer to a real market economy raises the issue of profits – which weren’t an issue in the first model. For this economy to be in equilibrium, the rate of profit has to be the same across all sectors – even if only one sector produced a physical surplus. Otherwise, capitalists in sectors with a low rate of profit would be tempted to move to sectors with a high rate of profit, and the economy would not be in equilibrium.\(^\text{341}\)

In other words, in an economy with a surplus the factors of production determine the prices. “For a uniform rate of profit \(r\) to apply, the prices in the economy must be such that the ‘money’ value of inputs, multiplied by \((1+r)\), must equal the money value of its outputs.”\(^\text{342}\)

Here again, Sraffa highlights the requirement for a physical basis for monetary profit; if such profit is going to sustain unproductive consumption, or allow for actual capital accumulation and the expansion of productive resources. In equilibrium the price mechanism redistributes the real material surplus or monetary access to such surplus, in proportion to the levels of investment in particular enterprises and industries.

3. Production with a surplus and explicit labour

The next model added further realism by showing that output was produced by combining both commodities and labour in a production process. This introduces the wage as an additional unknown, and establishes the first element in Sraffa’s critique of the economic theory of income distribution: rather than prices determining the distribution of income, the distribution of income between wages and profits must be known before prices can be calculated. Sraffa then shows that there is an appropriate measuring stick (the ‘standard commodity’) which reveals a simple linear relationship between the wage \(w\), the actual rate of profit \(r\), and the maximum feasible rate of profit for a given economy \(R\). The wage \(w\) falls linearly as the rate of profit \(r\) rises towards its maximum value \(R\).\(^\text{343}\)

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\(^{341}\) Ibid
\(^{342}\) Ibid
\(^{343}\) Ibid, pp139 and 140
Keen illustrates this linear relationship using a sample economy with a “maximum rate of profit of 25%” and wages that represent 80% of the economy’s surplus output. In Keen’s example

If workers, for example, get a zero wage, then all of the surplus goes to the capitalists, who then make a profit of 25%. If, however, workers get 10% of the surplus as their wage, then the rate of profit falls to 23% (rounded up). The same linear process continues right out to the point at which workers get 100% of the surplus, at which point capitalists get nothing and therefore have a rate of profit of zero.

Sraffa’s model explains how prices, wages and profits are interlinked and this is seen as the greatest strength of the model. Using Sraffa’s model it is clear that “when the economy produces a surplus, the wage rate determines the proportion of that surplus to be appropriated by workers. The higher the wage the greater the workers’ share of that pie and, conversely, the lower the wage, the greater the employers’ profit.”

Even if there were perfect markets or market competition, the neoclassical moral view of profit as a just desert to the owner of capital and, wages as a just desert to the labourer is not sustainable. The relationships in the free markets are based on exchanges, exchange of goods, labour and capital for money that allow all participants to maximise their utility. “This is what appears to occur under capitalism … (but only) … if one deliberately refuses to examine the unique social conditions which create the very peculiar and ‘exceptional’ exchange between labour and capital.” As Mandel says,

In the first place, there is an institutional inequality of conditions between capitalists and workers. The capitalist is not forced to buy labour-power on a continuous basis. He does it only if it is profitable to him. If not, he prefers to wait, to lay off workers, or even to close his plant down till better times. The worker, on the other hand …, is under economic compulsion to sell his labour power. As he has no access to the means of production, including land, as he has no access to any large-scale free

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344 Ibid, p140
345 Ibid
346 Ibid
348 Ibid
stock of food, and as he has no reserves of money which enable him to survive for any length of time while doing nothing, he must sell his labour power to the capitalist on a continuous basis and at the current rate. 350

This statement represents the power imbalance that exists between the employers of labour and labour in Australia today. In Australia, the NSW Office of Industrial Relations has defined the task of trade unions as “representative organisations they campaign on behalf of their members to achieve the best possible working conditions, and represent employees in disputes and negotiations. They also lobby government in relation to a variety of issues including taxation, superannuation, childcare and social justice matters.” 351 In other words, the task of trade unions is to attempt to redress the power imbalance between labour and capital. Neoclassical economists would view trade unions as ‘market imperfections’ attempting to influence the activities of the free market. In Australia, conservative Federal governments since 1996 have “ushered in legislation that would undermine the ability of unions to access workplaces, introduced an individual bargaining stream that explicitly excluded unions from involvement, and saw a growing encouragement by government of antiunion behaviour.” 352 In neoclassical terms, this antipathy to trade unions is consistent with a belief in the operation of free markets. As trade unions can provide workers with reserves to withstand unattractive offers of wages for their labour then they are market imperfections that must be eliminated.

Taxation is all about allocating surplus between members of a society. Taxation is the tool whereby any injustices that arise in the allocation of profits between the employers of labour and labour, because of the power imbalance between them, may be democratically redressed.

**John Kenneth Galbraith**

While Galbraith was writing *The Affluent Society* in the 1960’s, “a further and larger world began obtruding itself on my thoughts. This was the world of great corporations – a world in which people increasingly served the convenience of those organizations which were meant to serve them. (Galbraith’s emphasis)... So far from being the controlling power in the

350 Ibid, pp47-48
In the 1960’s Galbraith attempted to analyse what was actually occurring in the society in which he lived, post World War 2, USA. Galbraith recognised and quantified the concentrations of economic power held by the major corporations in the US and he recognised that this New Industrial State had profound consequences for the neoclassical economic theories of the economy, firms and profits. Galbraith deconstructed the myth of the neoclassical economists’ claims ‘to objectively analyse the economy as it actually is’ replacing their positive economics with an analysis more akin to the work of John Stuart Mill than the later neoclassical economists.

Galbraith recognised that the “decisive power in modern industrial society is exercised not by capital but by organization, not by the capitalist but by the industrial bureaucrat. This is true in Western planning systems. It is also true in the socialist societies.”

**Galbraith Market Theory**

Neoclassical economists, as shown above, regard the perfectly competitive market as the normal way a market economy is organised. They believe that market imperfections, epitomised by oligarchy and monopoly, self-equilibrate toward a competitive market as other firms enter the market so eliminating monopoly profits. Neoclassical economists also view capital as homogenous and interchangeable. Galbraith, on the other hand, recognised that the normal way a market economy is organised is by large firms operating in conditions of monopoly or oligarchy, the perfectly competitive market, if it exists is irrelevant to the operation of the economy because it is only an insignificant part of the economy. Galbraith saw that the “imperatives of technology” the need for large investments of capital (immovable, industry specific and complex), made it essential for firms to plan. This planning was not on how to serve the market but on how to replace the market by “obtaining the prices, costs and consumer and producer response that it wants.”

Galbraith recognised that the modern market economy was sharply divided between those economic actors, major corporations, which wielded power over the market and the majority of economic actors, consumers and small firms, which wielded no power over the

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353 Galbraith JK, *The New Industrial State*, as above, p ix
354 Ibid, p xv
355 Ibid, Chapter II, pp11-21
356 Ibid, p xvi
markets. Galbraith divides the modern economy into those two, unequal parts. The larger part he calls the planning system – that is, “the system of manufacturing, merchandising, transportation, power and financial corporations producing approximately half of all the goods and services not provided by the state.”

In describing the US economy Galbraith continues, “making up the remainder of the economy are around twelve million smaller firms, including around three million farmers whose total sales are less than those of the four largest industrial corporations;….”

Galbraith calls the plethora of small firms, those firms still subject to the forces of the market, the market economy. The large firms, those who set the prices and are largely above the market, he calls the planning system.

Since Galbraith wrote about the planning system in the 1970’s the market concentration of major corporations has become even more pronounced.

Progressively large-scale transnational mergers in the 1990’s, combined with strategies of manufacture-market integration, have established interlocking oligopolist structures in the production and sales of, inter alia, consumer durables, mass media products, cars and trucks, food processing, computers, electronic components, airlines and aerospace products, oil, steel, chemicals, and pharmaceutical and biotech products.

McMurtry believes that Galbraith’s identified tendency for production and economic organisation to oligopoly has now become a tendency to monopoly. He observes that by the 1990’s the “largest 300 corporations, for example, control 98 percent of all foreign direct investment and 60 percent of all land cultivated for export.”

The market economy – the powerful symbol of neoclassical economists that supports values such as just deserts and free exchange is increasingly, irrelevant. The numbers of firms that are still subject to the forces of the market are economically irrelevant. That there is an ever

358 Ibid, pp42-43
359 Ibid, p43
360 Ibid, p44
361 Ibid
362 Ibid
363 Ibid
Diminishing number of firms that now control economic life has become the norm. The planning economy identified by Galbraith has become the model of western capitalist production and distribution.

**Galbraith Theory of the Firm**

The neoclassical theory of the firm, as iterated above, is that all firms seek to maximise profits and are therefore subject to the relentless demands of the market and therefore to consumers who keep the market operating efficiently by making rational choices. Galbraith maintains that this idea, that firms are subordinate to the market “is not politically neutral; its pedagogy persuades the innocent (the consumer) that they have a power they do not possess and diverts attention from those who do wield the power.”\(^{364}\) Galbraith takes the neoclassical profit maximising position to its logical conclusion that, in order for firms to maximise profits they must tend toward oligopoly and monopoly and control the market. As Galbraith acknowledges, this tendency is exacerbated due to the fact that maintaining profits becomes more dependent on increasingly complex and expensive technology and infrastructure to produce the goods required by the market. As Stillwell remarked above, the market and the system of firms are the antithesis of each other. Galbraith recognises many types of firms, not as profit maximising entities, but as firms that are subject to the market and firms that “reflect varying degrees of adaptation to the requirements of planning and the needs of the technostructure.”\(^{365}\) In other words, firms that control the market with varying degrees of dominance and control. The control that firms must exercise in order to mobilise the technology they require to produce goods in volume and complexity for modern needs “control of supply, control of demand, provision of capital, minimization of risk.”\(^{366}\)

Galbraith sees the firm, the corporation as an “apparatus for group decision-making”\(^{367}\) that requires high levels of autonomy. The threats to firm autonomy are the;

1. State,
2. Trade unions,
3. Shareholders,
4. Other providers of capital, eg banks and
5. A failure of earnings\(^ {368}\)

Major firms, in Galbraith’s view, have protected themselves from these threats to their autonomy by;

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\(^{364}\) Galbraith JK, *The New Industrial State*, as above, p xiii  
\(^{365}\) Ibid, p77  
\(^{366}\) Ibid, p81  
\(^{367}\) Ibid  
\(^{368}\) Ibid, pp81-86
1. Strong resistance to government interference in the internal affairs of corporations. An effective tool that keeps state interference to a minimum is the strong belief in the market, the belief that the firm is subservient to the market and that the market is the most efficient way of allocating resources. In 1976 when Galbraith completed his third edition of *The New Industrial State*, “the five largest industrial corporations… had just under 13 percent of all assets used in manufacturing. The 50 largest manufacturing corporations had 42 per cent of all assets. The 500 largest had 72 per cent.” Even though by 1976 the evidence was there to suggest that firms were controlling the market, not the other way around, this belief in the markets persisted. This belief still persists, even though concentrations of corporate power have continued to increase since 1976.

2. In Australia the governing boards of companies do not include nor are they required to include any trade union representation.

3. Shareholders have been excluded from exercising power over corporations by the fact of widely dispersed share ownership and the fact that shareholders vote on a narrow range of decisions, approving the annual reports, appointing the Board of Directors and recently in Australia, approving management salary packages. In fact shareholders vote in accordance with management directives. As Galbraith put it, the shareholder “can vote but his vote, if for management, is unnecessary and if against, futile. In other words, it is valueless.” Galbraith concludes, that the modern shareholders’ only power is to sell the shares if dissatisfied with the company.

4. Other providers of capital to firms, such as banks may seek to impose conditions on a firm in order for them to advance funds. Galbraith has concluded that firms have overcome this possibility by becoming reliant for new capital on their own retained earnings, “it is hardly surprising that retained earnings of corporations have become such an overwhelmingly important source of capital.”

5. The risk to firms of a failure of earnings has been minimised by the size of the modern corporation and the breadth of their activities. Recent major corporate failures, such as Enron and HIH (in Australia), have been due to corporate fraud, not a failure of the activities of the corporation. In early 2008 a major European Bank, the French Societe Generale, made losses of 4.9 billion Euros ($8.2 billion) as a result of trading by a single

369 Ibid, p81
370 Ibid, pp77-78
371 Ibid, p84
372 Ibid, p85
bank officer trading outside his limits. Even though this loss means that the bank may have to seek additional capital from the market, a failure of earnings of this magnitude has not actually put the bank at risk of failure. To get an idea of the magnitude of the loss, as at the end of 2006 the total French foreign reserves amounted to 33.9 billion Euros, making the bank loss equivalent to 14.45% of France’s foreign reserves.

Galbraith Theory of Profits

In Galbraith’s planning economy prices, and therefore profits, are controlled by the producer firms whereas in the neoclassical model prices are set by consumers, that is, by the market.

Producers in the planning economy are able to control their prices because the other major firms in the market are complicit in the control of prices and the remaining firms, if any, are too small to impact on the market prices. Galbraith is not suggesting that price setting complicity consists of illegal price fixing, although it can be, but a complicity of self interest.

A recent example of illegal price-fixing was when one of the duopolists in Australia’s cardboard packaging market, Visy Board was fined $36 million “for engaging in a four-year price-fixing and cartel scheme with packaging rival Amcor.” The scheme was estimated to have impacted 90% of the Australian cardboard box market.

The complicity that Galbraith is referring to is the complicity of self-interest. Price-cutting behaviour would lead to a loss of control over the market and a loss of control over profits, therefore the firms in the market would desist from such behaviour. As Galbraith says, the “danger is recognised by all. In the planning system there is, accordingly, a convention that outlaws such behaviour. It is almost perfectly enforced.”

An example of this complicity of interest is in Sydney, where fuel prices have been rising and falling in a weekly cycle for years. Every Wednesday afternoon prices all over the city rise from the morning price by about 14 cents per litre. Then the prices fall gradually, reaching a low point on Wednesday morning when the cycle repeats itself. Even though consumers recognise the price fixing

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375 John Kenneth Galbraith, *Economics and the Public Purpose*, as above, Chapter XII
377 Ibid
378 John Kenneth Galbraith, *Economics and the Public Purpose*, as above, p115
going on by the suppliers there has not been a single prosecution of fuel suppliers for price fixing. The fuel price cycle in Sydney, although not a breach of the anti price fixing laws is an example of the ‘perfect enforcement’ of the convention by the fuel suppliers in Sydney to keep prices in tandem with each other. The Australian Competition and Consumer Commission, recognising its inability to do anything about this behaviour, even publishes petrol price graphs each week for major Australian capital cities in order to assist consumers to purchase fuel on the ‘cheap’ days in their city.\(^{379}\)

Galbraith believes that in the planned economy producers have to set prices, not in order to maximize profits but to secure a level of earnings which “has the primary effect of sustaining and expanding sales.”\(^{380}\) This is because Galbraith recognises that in the capital assumptions of the neoclassical economists do not hold for the planned economy. In the neoclassical market economy it is assumed that technology is simple, capital unspecialised, production lead times short and capital is easily transferable between industries.\(^{381}\) Galbraith however recognises that the opposite is actually true, that is, in the planned economy, technology is complex, capital highly specialised, production lead times long and, capital is not easily transferable between industries. In addition, the costs of the organisation needed to support highly complex manufacturing processes is large and not easily reduced.\(^{382}\)

The other reason prices need to be controlled by producers, and not consumers in the planning economy, is so that “they can be raised to offset increases in costs that are not similarly under control.”\(^{383}\) Galbraith gives the example of wages which may be out of the control of the producer and states that the fact “that price increases usually follow wage negotiations shows, more than incidentally, that profit maximization is not a purpose of the technostructure.”\(^{384}\) This follows because, “if revenues can be increased just after a wage increase, they could obviously, have been increased well before.”\(^{385}\) Galbraith believes that firms use wage increases as a reason to increase prices to more than compensate for the wage increase and thereby “rectify the level of earnings in favour of the firm.”\(^{386}\)


\(^{380}\) John Kenneth Galbraith, *Economics and the Public Purpose*, as above, p115

\(^{381}\) Ibid, p112

\(^{382}\) Ibid, p113

\(^{383}\) Ibid, p118

\(^{384}\) Ibid

\(^{385}\) Ibid

\(^{386}\) Ibid
The Conflict Theory of the Firm

The work of Sraffa demonstrates that firms do produce surpluses and those surpluses are allocated between labour (in the form of wages) and capital (in the form of profit) based on the relative bargaining power of both. Galbraith has demonstrated that firms set prices, not so as to maximise profits, but so as to secure earnings to sustain and expand sales and so secure the future of the firm.

The conflict theory of the firm, promulgated by a “number of political economists over the past thirty years”[^387], takes the above work a step further. This theory recognises that “profits depend not only on the size of net output – productivity – but on how the net output is divided between wages and profits.”[^388] That is, profits are a surplus produced by the mixing of labour, capital and materials and, those profits are divided between labour and capital. The conflict theory of the firm proposes that rational producers, wishing to maximise profits will “choose less efficient technologies if more efficient technologies lower their bargaining power over their employees.”[^389]. The example given by Hahnel is where the efficient technology requires skilled workers working in teams, these skills and team based work will strengthen the employees wage bargaining abilities. In this case the employers may choose the less efficient technology of, say, an assembly line which needs unskilled workers working in isolation. These workers will have low wage bargaining abilities and if the “bargaining-power effect outweighs the productivity effect”[^390] employers will opt for the less efficient technology.

Conclusion

Prevailing economic ideology has a profound impact on taxation policy. The ideology provides the moral justification of fairness for imposing taxes between people in society.

As seen in Chapter two the classical economists, starting with Adam Smith, held that when it came to taxation there should be ‘equality of sacrifice’ between taxpayers. For Smith equality of sacrifice meant that “The subjects of every state ought to contribute towards the support of government, as nearly as possible, in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.”[^391] JS Mill envisaged a comprehensive system of taxation that he believed would result

[^388]: Ibid
[^389]: Ibid
[^390]: Ibid
in equality of sacrifice. Mill’s proposed taxation system exempts income required to provide the ‘necessities of life’, would be progressive on incomes that increased through no effort on the part of the recipient (e.g. rising rents) and was imposed on inheritances and wealth.

The social liberal view of profits is as a surplus, generated by mixing labour and capital, which will be distributed between workers and employers in the form of wages and profits depending on the relative social and institutional power of the two sides.\textsuperscript{392} This view of the distribution of income as a power struggle between labour and capital sees taxation as a vehicle for redressing any injustices that occur because of power imbalances between labour and capital. Social liberals would then see progressive income taxes and the taxation of profits as a just redistribution of income.

The currently prevalent neoclassical view of profits is that of profits are ‘just deserts’ and therefore a view that profits should not be taxed at all (Milton Friedman) or only lightly taxed.

Chapter 4 The History of the Corporation and the Lie of Limited Liability

Introduction

The justification for the existence of companies and company law underpins the western model of capitalism and “provides the theoretical justification for the basic organisation of industry and commerce throughout most of the western world.” Even though “the ownership and control of business enterprises, and the distribution of profits arising in them, can be structured in any number of ways … the important question is how we came to accept as so fundamental the structure which we now have”, that is, the structure of the limited liability company. In other words how is it that the corporate form of business organisation is accepted almost unquestioningly as the basic form of business organisation in the western world?

The history of the limited liability company discloses that:

1. Promoters of the corporate form have from the earliest days advanced the company as a way of doing business ahead of legislation providing the legal framework for companies. A pattern emerged of business practices being undertaken in advance of any legislation to regulate the practice. Legislators are constantly playing ‘catch-up’ with the practices of the corporate community.

2. The ‘need’ for limited liability as a pre-condition of the success of the corporate form was a fraud perpetrated by supporters of the idea on the legislators of the time.

The abuse of limited liability continues with disastrous consequences for all victims of limited liability companies. These victims include shareholders, other investors, creditors, employees, customers, the environment and even national economies.

This discussion only considers the limited liability of corporations of publicly traded shares. The small private company, called the closely held company in some jurisdictions, is not considered here. This is because in small companies “shareholders do possess the actual

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393 Hadden T, *Company Law and Capitalism*, published by Weidenfeld and Nicolson, London, 1972. At the time of publication Hadden was Lecturer in Law in the Queen’s University of Belfast, p4

394 Ibid
ability to control.”  

As well, in practice “limited liability is not of particular consequence for the very closely held corporation, given the likelihood that voluntary creditors will ask for personal guarantees and that shareholders, acting as corporate agents, will already be liable for their own torts.”

**A Short History of the Limited Liability Company**

Early forms of company association were called joint stock enterprises because they were usually formed to undertake a single trading venture and dissolved on the completion of the venture.

“The idea of a commercial enterprise in which risk and profit are shared between financiers and traders as joint participants is as old as western civilization itself. Wealthy nobles and merchants in Greece and Rome, and later in the Italian city states, habitually contributed to the initial outlay and expenses of trading expeditions and ventures undertaken by shipowners and other traders in return for a share of the eventual profit. The legal rules of the *commenda*, perhaps the earliest formalized system of commercial joint enterprise, facilitated this type of transaction by allowing the liability of the investor, who had no direct control over the conduct of the venture, to be limited to the amount he had contributed. Apart from this the ancient world did not produce any lasting form of trading association. But Roman lawyers did develop the concept of an association of persons, the *societas*, with legal rights and duties independent of its individual members, which laid the foundation of the modern idea of the company as a separate legal entity.”

These early forms of association were developing most of the important characteristics still present in the modern corporation. The characteristics of:

- Providing substantial capital sums not available to an individual in order to undertake a trading venture.
- The separation between the investors and the persons controlling the enterprise, the birth of the managerial class. Ownership of an enterprise in this way became “regarded as a matter of financial rather than personal participation.”

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396 Ibid, p1402
397 Hadden T, *Company Law and Capitalism*, as above, pp4 - 5
398 Ibid, pp7 - 8
• The enterprise became a legal entity separate from the investors and the people managing the enterprise.

• The liability of the investors could be limited to the amount invested in the enterprise. In the early commendas limiting the liability of investors did not have the same ramifications of limited liability in the modern corporation. This is because the commendas were only formed to undertake single trading ventures. If the venture failed the losses were limited to the venture and the persons suffering the greatest loss were the investors.

The substantial features not included in the early English joint stock enterprises, the forerunner of the modern Australian corporation and characteristic of the modern corporation in the world are;

• The individual investor was unable to withdraw his investment “without injuring or interrupting the affairs of the company.” This shortcoming, from the investor’s point of view was remedied in England, at least, by “as early as the sixteenth century (when) shares were sold outside personal acquaintances, and without limiting conditions.”

• The early forms of joint stock enterprises were formed for a single trading venture. In England the nature of joint stock enterprises broadened to become vehicles for continuing operations, other than one-off trading expeditions, that required large sums of capital. An early example was the Company of the Mines Royal, founded in 1564 “from the start on a joint stock basis, twenty-four shares being issued at an average price of £1,000.” This company was founded to mine copper. In the period between 1530 and 1707, when all joint stock enterprises were founded by grant of a Royal charter, joint stock enterprises were formed for many purposes including;
  - Exploration
  - Protection of inventions
  - The grant of Royal monopolies
  - Colonisation
  - Mining
  - Fishing

399 Ibid, pp8 - 9
400 Ibid, p7
401 Ibid
402 Ibid
403 Carr CT (editor), Select Charters of Trading Companies AD 1530-1707, published by the Seldon Society, London, 1913, pxi
Limited liability was not a normal feature of the early joint stock enterprises. In the case of *Salmon v The Hamborough Company*[^404], the plaintiff, Doctor Salmon had lent the Company £2,000 on the security offered by the Letters Patent incorporating the Company which provided that the Company “had Power to make By-Laws, and to assess rates upon Cloaths (which was the commodity they dealt in) and by Poll upon every Member to defray the necessary charge of the Company”.[^405] The Company “refused to exercise that power”,[^406] and “tho’ several times summoned did not appear”[^407] before the court. The court ordered the Company to make the necessary levy upon its members in order to pay the debt owed to Doctor Salmon. The court also ordered that if the Company failed to obey the orders then contempt proceedings would be issued against all the members of the Company and the court would levy the members in order to pay the debt owed to Doctor Salmon[^408].

Many of the features of the modern corporation were practiced by the older form of corporation ahead of the law that granted these early corporations their existence. For example, the Company of Mineral and Battery Works were created by Charter in 1565, with capital of thirty-six shares. The company raised further capital by making calls on these shares even though the “charters granted to these companies did not include any express power to raise capital in this way.”[^409] This commercial practice, of raising further capital from shareholders by making calls on the shareholders, was not reflected in the law, that is, in the charters creating companies until much later, in 1603[^410]. It took the law almost forty years to legalise this practice.

These early corporate forms became so popular that by “the middle of the seventeenth century the ownership of a share had clearly become to be regarded as a matter of financial rather than personal participation. And by the end of the century there was a flourishing public market in London for the shares of all the major companies.”[^411] This flourishing public market meant that company members/shareholders no longer saw themselves as providers of capital to establish new enterprises content to earn a return on the capital.

[^404]: [1671] 1 Chan. Cas, 204 at 763
[^405]: Ibid
[^406]: Ibid
[^407]: Ibid
[^408]: Ibid at 764
[^409]: Hadden T, *Company Law and Capitalism*, as above, p7
[^410]: Ibid
[^411]: Ibid, pp7,8
invested. Shareholders, from these very early days, were not content to wait to earn income from dividends to be paid out of the profits of the companies in which they had invested. Instead members became speculators, gambling on shares in the same way as one would gamble on horses with inside information. As early as 1696 the Commissioners of Trade reported

The pernicious art of stock jobbing so wholly perverted the end and design of companies and corporations erected for the introducing or carrying on of manufactures to the private profit of the first projectors, that the privileges granted to them have commonly been made no other use of by the first procurers and subscribers but to sell again with advantage to ignorant men, drawn in by the reputation, falsely raised and artfully spread, concerning the thriving state of their stock.

These comments were provoked by a “rapid succession of booms and slumps” between 1690 and 1695 such that “of ninety-three joint stock companies known to have been trading between 1690 and 1695 only twenty could be traced in 1698.” The Commissioner’s report “lead to the passing of an Act in 1697 to regulate and control the buying and selling of stock.” The Act did nothing to regulate the trade because it failed to provide any remedies. “The only effective means of control was through a parliamentary petition and investigation, which could only be resorted to in extreme circumstances.”

In 1711 the South Sea Company was established “with a monopoly (granted to it by the English government) of trade with Spanish America”. When this trade virtually disappeared due to the war between England and Spain in 1719 the company, in January 1720, persuaded the English government to allow the company “to take over the entire British national debt” for shares in the company. Despite this assistance, the company collapsed by June 1720 because of substantial mismanagement. However, this occurred after a capital raising lead to speculative trade in the company’s shares pushing the share price

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412 Stock jobbing – selling shares in companies in a public market. The modern definition of the stock market is ‘a market, exchange or other place at which, or a facility by means of which, securities are regularly offered for sale, purchase or exchange.’ Corporations Act 2001 s9, until the definition was repealed by No 122 of 2001, effective 11 March 2002.
413 Hadden T, Company Law and Capitalism, as above, p9
414 Ibid
415 Ibid
416 Ibid
417 Ibid, p10
419 Ibid, pp32,33
from £128 per share, the subscription price, to a high of £950 a share.\textsuperscript{420} After the collapse of the share price and then the company this affair became known as the ‘South Sea Bubble’.

The success of the South Sea Company’s capital raising lead to a “flood of proposals for new companies”\textsuperscript{421} competing directly with the South Sea Company for capital. The directors of the South Sea Company, in an effort to maintain the bubble that they had created, persuaded “their political allies to pass the ironically named Bubble Act of June 11, 1720.”\textsuperscript{422} Haddon records the attempt to save the South Sea Company more bluntly, he states:

The so-called Bubble Act was rushed through in 1720 as part of a final effort to shore up the market for South Sea shares by suppressing some of its competitors, made it a criminal offence to form any company ‘presuming to be a corporate body’ or to raise transferable stocks without legal authority.\textsuperscript{423}

The Bubble Act failed in its attempt to rescue the South Sea Company and by “October, the Company’s share price was back to £170.”\textsuperscript{424} In the end the company could not be saved and “the government effectively nationalized the Company, leaving the investors with large losses, but saving most of the financial system.”\textsuperscript{425}

The result of the Bubble Act was that “apart from some few larger enterprises of a semi-public nature which were able to secure charters, such as the new canal companies, the commercial community was forced to operate within the limits of the unincorporated partnership”,\textsuperscript{426} but not for long. By 1795 the business community was widely ignoring the Bubble Act “and full scale companies began to spring up again in the main commercial centres. … These new companies were similar in all but their legal status to the chartered companies created by the Crown or by Act of Parliament, but they were subject to none of the official controls on formation which formal incorporation involved.”\textsuperscript{427} Actually, these new companies were illegal and unsurprisingly, “proceedings were eventually brought against companies of this type on the grounds of their blatant breach of the provisions of the Bubble Act.”\textsuperscript{428} These illegal companies, operating outside the law, were started by businessmen who wanted to limit their liability and wanted to trade in their shares but were

\textsuperscript{420} Ibid, p32
\textsuperscript{421} Wooldridge A, Company: a short history of a revolutionary idea, as above, p32
\textsuperscript{422} Ibid
\textsuperscript{423} Hadden T, Company Law and Capitalism, as above, p10
\textsuperscript{424} Wooldridge A, Company: a short history of a revolutionary idea, as above, p32
\textsuperscript{425} Ibid, pp32-33
\textsuperscript{426} Ibid, p32
\textsuperscript{427} Hadden T, Company Law and Capitalism, as above, p13
\textsuperscript{428} Ibid
not willing, or able, to gain official status by seeking to have their enterprises chartered within the law. In view of the fact that the breaches were ‘blatant’ it is difficult to comprehend what happened next. Haddon continues,

the judges were clearly reluctant to hold that all large unincorporated associations were illegal. The whole operation in fact did little more to highlight the absurdity of the old law. And eventually in 1825, probably as a result of the official embarrassment caused by a sudden spate of new unincorporated associations’ flotations, the Act was repealed. More important, Parliament was induced to provide additional powers for the Crown to facilitate the creation of chartered companies on increasingly standardized terms.429

But why? The old law was not absurd. It attempted to regulate and restrict the formation of new companies in an attempt to protect potential investors and creditors. Why were the judges ready to condone illegal acts when stealing was a capital offence? When people were still being transported to the penal colony of New South Wales for much smaller crimes? These illegal companies had the power leave creditors unpaid and with no practical form of redress. Why did Parliament bow to a lobby and ‘facilitate’ what had been illegal? Could it be that moneyed and relatively powerful people were investing in illegal companies? Victims of these companies were likely to be small creditors unable financially to seek legal redress against the shareholders. Could it also be that people transported and imprisoned for crimes such as stealing were generally poor?

Even though companies with limited liability and with a legal personality distinct from their shareholders had been dealt with in English law since the sixteenth century the concept of the company as a legal person distinct from its shareholders was not finally settled until 1897. In 1897 the case of Aron Salomon v A. Salomon and Company Limited430 was finally, on appeal from two earlier contrary decisions431, decided, unanimously, by the House of Lords that

the company had conducted the business in its own right and for itself beneficially and neither as agent or trustee: it was not just an alias for Salomon. The seven persons required for the formation of a company did not have to be independent of each other. Salomon was not liable to indemnify the company. Hence the debt for

429 Ibid
430 [1897] AC 22
which security had been given to Salomon could rank before unsecured debts in the
distribution of the company’s assets.\footnote{432}

In the statement of facts it was disclosed that the shareholders of A. Salomon and Company Limited were “the appellant, his wife, a daughter and four sons.”\footnote{433} This decision overturned the decision in the Court of Appeal ([1895] 2 Ch. 323) where the view of Vaughan Williams J. was “that the company was the mere alias or agent of the appellant so as to make him liable to indemnify the company against creditors.”\footnote{434} In other words the court attempted to hold A. Salomon liable for the debts of the company on the basis that the other shareholders were ‘mere dummies’ and that A. Salomon ran the business as if he were a sole trader. The earlier decisions in this case attempted to ignore the legal personhood granted by incorporation.

In his decision in the final appeal case, Lord Herschell held that the “very object of the creation of the company and the transfer to it of the business is, whereas the liability of the partners for debts incurred was without limit, the liability of the members for the debts incurred by the company shall be limited.”\footnote{435}

It took English law around 300 years to finally accept the distinct legal personality of companies and the limited liability of their members. Which makes it all the more surprising that, in the barely 100 years since the decision in \textit{Salomon v Salomon & Co Ltd}, the concept of limited liability is now taken for granted. A standard company law text, \textit{Ford’s Principles of Corporations Law}, in chapter one titled, The Nature and Functions of Companies, states the “privilege of limited liability achievable by formation of a company is not a fundamental human right. It is a franchise given by society to save the members from having to seek limitations of liability by more cumbersome means.”\footnote{436} The more cumbersome means of limiting liability are to be found in contract law that “provides a rudimentary and incomplete facility.”\footnote{437} Ford holds that limiting liability through contract “is not satisfactory in business because care would have to be taken to ensure that each contract contained the stipulation and, in informal contracts, it would be necessary to show that the other party was aware of them. Moreover, it cannot protect against unexpected liability such as vicarious liability for

\footnotesize{\textit{\textsuperscript{432} Ibid, p113}}\textsupersize{\textit{\textsuperscript{433} [1897] AC 22 at 23}}\textsupersize{\textit{\textsuperscript{434} [1897] AC 22 at 27}}\textsupersize{\textit{\textsuperscript{435} [1897] AC 22 at 44}}\textsupersize{\textit{\textsuperscript{436} Austin RP and Ramsay IM, \textit{Ford’s Principles of Corporations Law}, as above, p6}}\textsupersize{\textit{\textsuperscript{437} Ibid}}
torts committed by employees in the course of their employment. Insurance is then needed.\textsuperscript{438}

Ford acknowledges that a “company can be constituted as an unlimited company whose members stand to lose all their property if their company is wound up without being able to discharge all its debts in full.” Not an attractive prospect for members, but an attractive prospect for those doing business with such a company. Creditors would be heartened to know that the personal assets of the owners of a company were at stake if the company failed. This would give the creditors increased assurance that they were dealing with reputable people it would also give them increased payout in the event of company failure.

The Arguments that built the Limited Liability Company

When the concept of limited liability was being advocated in England the main arguments in favour of limited liability were that limited liability would:

1. Encourage capital accumulation necessary to power the industrial revolution.
2. Encourage broad participation in the stock market which would improve law and order

1. Encourage capital accumulation necessary to power the industrial revolution.

An essential requirement of modern capitalism is large agglomerations of capital. Haddon, and many corporate commentators, hold that the ability to raise capital from large numbers of investors who are able to withdraw their capital from an investment without damaging the investment makes the corporate form essential to capitalism. It was considered that unlimited liability would “discourage men of substance from buying shares in enterprises in which there was any degree of risk”\textsuperscript{439}.

There are three major problems with this argument.

Firstly, ‘men of substance’ who held the majority of the shares in a corporation should be bearing the risks of that corporation disproportionately to more modest shareholders. This is because majority shareholders are the shareholders with more of a say in the decision making process of the company and so should carry the risks associated with their decisions. Men of substance are also far more likely than smaller investors to be able to hold substantial

\textsuperscript{438} Ibid
\textsuperscript{439} Hadden T, \textit{Company Law and Capitalism}, as above, p16
shares in a company and be able to diversify their risk by making substantial investments in many companies.

The founding father of modern economics widely agreed to be Adam Smith published his great economic treatise, *An Inquiry into the Nature and Causes of the Wealth of Nations*, in 1776. In it Smith states that “The wealth of a nation results from the diligent pursuit by each of its citizens of his own interests – when he reaps the resulting reward or suffers any resulting penalties. In serving his own interests, the individual serves the public interest.” Smith was clearly no advocate of limited liability believing that only a diligent pursuit of ones’ own interest, where the consequences of success and failure are borne by the individual, is the public interest best served.

Secondly, before the advent of the limited liability joint stock enterprise or company in England in 1856 the railway boom, which required huge sums of capital, had proceeded unimpeded by the disadvantage of unlimited liability. In England, “between 1825 and 1849 the amount of capital raised by railways, mainly through joint-stock companies increased from £200,000 to £230 million, more than one thousand fold.” The lack of ‘protection’ afforded to investors by limited liability was clearly no bar to capital accumulation.

Before the industrial revolution in England early joint stock enterprises such as the Company of Mines Royal which emerged in the 1560’s did not enjoy limited liability. This company had no difficulty raising capital issuing 24 shares, each share “representing a paid-up contribution of £1,200.” The company failed to make profits in its early years and shareholders faced “continued demands for more capital to meet current expenses (which) threw an ever-increasing burden on the partners, in some cases beyond their means.” Where the original shareholders could not afford to pay the capital calls they merely sold their shares, or fractions of their shares, to other investors who were able to make the payments. There was no lack of persons willing and able to contribute the capital required despite the risk of unlimited liability.

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441 Ibid, p17
444 Ibid, p375
445 Ibid
Thirdly, the degree of financial risk that attached to holding a share in an unlimited liability joint stock enterprise was in practice negligible.

The system for liquidation with full liability for all shareholders which was adopted in 1844, however, was soon shown to be virtually unworkable in the aftermath of important failures in the later 1840’s … (because) … it was often impossible to ascertain which shareholders should be personally responsible in the event of a failure, since many of them were likely to have sold or bought their shares after the main losses had been incurred446.

This negligible risk is even more negligible for a shareholder in a listed company today. Shares in listed companies are held by individuals, insurance companies and superannuation funds and other companies and trusts and are constantly being traded. Any plaintiff seeking to allocate damages on the basis of the modern share register would face a costly, lengthy and practically impossible task. The difficulty of pursuing individual shareholders largely defeats the Adam Smith argument, encouraging the virtue of personal responsibility, above. However, if the loss were large enough for an individual or a class action against majority shareholders in an unlimited company, substantial shareholders could be pursued. The threat or fear of potential personal loss could make major shareholders act in a way envisaged by Adam Smith. That is, “the diligent pursuit by each of its citizens of his own interests – where he reaps the resulting reward or suffers any resulting penalties.” It seems eminently fair that the larger the shareholder, reaping the larger rewards, should be liable for the larger penalties.

2. Encourage broad participation in the stock market which would improve law and order

The committee that was established to consider limited liability, the Select Committee on Partnerships (England) 1851 reported that “Limited liability would allow those of moderate means to take shares in investments with their richer neighbours” and that this would mean that “their self-respect [would be] upheld, their intelligence encouraged and an additional motive given to preserve order and respect for the laws of property.”447

Broad participation in the stock market has been achieved in Australia. An Australian Stock Exchange (‘ASX’) study of share investors in 2004 revealed that, “55% of the Australian adult population, or approximately eight million people, owned shares directly or indirectly

446 Hadden T, *Company Law and Capitalism*, as above, p16
447 Bakan J, *The Corporation*, as above, pp11,12
(via a managed fund or self-managed superannuation fund). … Of the population, 44% or about 6.4 million, held shares directly.”

In 1851 broad participation in the stock market was promoted as an aid to self-respect, encouraging intelligence and in preserving law and order. There is no evidence to demonstrate that broad participation in the stock market does any of the things that were advanced as a reason for encouraging limited liability in 1851. Broad participation in the Australian stock market can be better explained by reference to the need for Australians to provide for their retirement as government guaranteed retirement schemes are abandoned. Australian shareholders are likely to be reluctant participants in the stock markets, goaded by the prospect of financial uncertainty in retirement. Although 44% of Australians who hold shares do so directly, this means that 56% hold shares indirectly. Small and indirect shareholdings, especially when motivated by fear of an impoverished old age does not appear to be a way of improving self-respect. In fact, having to own shares, possibly in companies selling drugs, alcohol, tobacco, arms, fossil fuels and following other dangerous pursuits could be seen as profoundly undermining self-respect and lead to feelings of disempowerment.

Adam Smith foresaw that broad participation in company ownership would necessarily divorce company ownership from management which would lead to less responsibility being taken by management and less regard for law and order. Smith was deeply opposed to joint-stock companies, the forerunner of modern corporations. Of the stockholders of these he said “… [They] seldom pretend to understand anything of the business of the company; and when the spirit of faction happens not to prevail among them, give themselves no trouble about it, but receive contentedly such half-yearly or yearly dividend, as the directors think proper to make them.” And of directors he added:

… being the managers rather of other people’s money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must prevail, more or less, in the management of the affairs of such a company … without an exclusive privilege … [joint-stock

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448 Australian Stock Exchange, *Australia’s Share Owners: An ASX study of share investors in 2004*, published by the Australian Stock Exchange Ltd, 2005, p4 Details of Australian stock market participation is attached as Appendix A to this chapter.

449 Galbraith JK, *The Age of Uncertainty*, as above, quoting Adam Smith, p264
companies] have commonly mismanaged the trade. With an exclusive privilege they have both mismanaged and confined it.450

The main argument against the concept of limited liability was that limited liability would:

Undermine Personal Responsibility
A parliamentarian speaking against the introduction of limited liability in England in the 19th century said that

“The first and most natural principle of commercial legislation … that every man was bound to pay the debts he had contracted, so long as he was able to do so” would be undermined by limited liability because it would “enable persons to embark in trade with a limited chance of loss, but with an unlimited chance of gain.”451

This sentiment was crudely but accurately expressed by Gilbert and Sullivan in 1893. Their operetta, Utopia, Limited, was scathing about the effects of limited liability provided by the corporate form. In the first act the concept of the limited liability was pithily explained.

Act 1 Mr Gold452
Make the money-spinner spin!
For you only stand to win,
And you’ll never with dishonesty be twitted.
For nobody can know,
To a million or so,
To what extent your capital’s committed!

If you come to grief, and your creditors are craving
(For nothing that is planned by mortal head
Is certain in this vale of sorrow – saving
That one’s Liability is Limited), -
Do you suppose that signifies perdition?
If so, you’re but a monetary dunce –
You merely file a Winding-up petition,

450 Ibid, pp264-5
451 Bakan J, The Corporation, as above, pp13
And start another company at once.
As a company you’ve come to utter sorrow –
But the Liquidators say,
“Never mind - you needn’t pay,”
So you start another company tomorrow!

The only damage that Gilbert and Sullivan had in mind when a company ‘came to grief’ was limited to leaving creditors unpaid. They underestimated the extent of the grief that could be caused by corporate collapse. This grief includes workers unpaid for their work, customers affected by shoddy or poisonous goods uncompensated for the damage they suffered, the environment left depleted and poisoned, and the list goes on.

The Modern Arguments that sustain the Limited Liability Company
Modern commentators supporting the existence of limited liability have updated the arguments in favour of limited liability. The modern arguments that sustain limited liability are that:

1. Limited liability promotes efficiency

2. Allows for perpetual succession

1. Limited liability promotes efficiency

It is argued that limited liability makes the operations of corporations and securities markets efficient. Efficiency is not defined and it is taken for granted that efficiency is a good. Australia’s Federal Treasurer, Peter Costello, when he was Shadow Attorney-General summarised the argument for limited liability by stating that

(t)he whole concept of the corporation is to limit the liability of persons who subscribe money or who control money in a collective enterprise so as to give them greater freedom to invest and use the money to create wealth and provide goods and services.


The existence of limited liability is taken to be “a logical consequence … for conducting economic activity.”\(^{455}\) The efficiency argument goes like this: modern production requires complex and diverse technology and large amounts of capital and this necessitates the separation of investment and management. Generally, workers lack capital and owners lack specialised production skills.\(^{456}\) “The costs of the separation of investment and management (agency costs) may be substantial. Nonetheless, we know from the survival of large corporations that the costs generated by agency relations are outweighed by the gains from separation and specialization of function. Limited liability reduces the costs of this separation and specialization.”\(^{457}\) Limited liability reduces the costs by:

a) Decreasing the need to monitor management because investors hold diversified portfolios and don’t have the expertise to monitor management.\(^{458}\)

This argument assumes that investors have sufficient funds and expertise to manage diversified portfolios of investments. Unfortunately, the smaller, less sophisticated investors are those who can least afford diversify (transaction costs) and can least afford to lose their capital. Evidence the distress of investors in the recent property fund collapses. For example, in July 2007 it was revealed that the property group Bridgecorp collapsed “leaving 18,000 investors dealing with losses that could top $450 million.”\(^{459}\) This equates to relatively ‘modest’ losses of only $25,000 per investor. However, as the receiver stated, “most of the company’s 18,000 investors were far from being high fliers who could afford to lose.”\(^{460}\) He went on to say, “Most of those I imagine are mums and pops at home, they tend to be the typical investors.”\(^{461}\) The collapse of Bridgecorp comes after the recent collapses of Westpoint, Fincorp and Australian Capital Reserve with combined losses estimated at $1.3billion.\(^{462}\) After the collapse of Bridgecorp finance experts agreed that “the signs of risk and potential disaster had been on the public record for some time.”\(^{463}\) Unfortunately, even though the financial experts may have known the risks, this information did not get down to the mum and pop investors who lost their savings or retirement nest eggs.


\(^{456}\) Ibid, p94

\(^{457}\) Ibid, p94

\(^{458}\) Ibid


\(^{460}\) Ibid

\(^{461}\) Ibid

\(^{462}\) Ibid

\(^{463}\) Ibid
Leaving management without oversight, from either investors or regulators, leads to the problems of negligence, mismanagement and the confinement of trade as predicted by Adam Smith above. There are many modern examples of this in major corporate collapses and corporate ‘confinement of trade’.

Recent examples of corporate collapses exacerbated by financial statement fraud of management include Enron, WorldCom, Sunbeam and Parmalat. A recent high profile example of ‘confinement of trade’ was revealed when British Airways, Korean Air Lines, Virgin Atlantic of Britain and Lufthansa of Germany agreed that they had been price fixing. The airlines were prosecuted by the US Department of Justice and the UK Office of Fair Trading. Between 2004 and 2006, when the conspiracy was uncovered, the airlines had charged long haul passengers a fuel surcharge of US$110, when the actual fuel surcharge cost the airlines about US$10 per trip. British Airways and Korean Airways agreed to plead guilty and pay separate fines of US$300 million in criminal fines. The two other airlines escaped being fined for agreeing to co-operate in the investigations. The fines will be paid to the US and the UK governments. Although the fines appear substantial, they have actually been reduced because the airlines pleaded guilty. The fines do not go to compensate passengers overcharged, in other words there is no compensation being paid to the victims of this crime.

b) Limited liability reduces the costs of monitoring other shareholders

The argument is that if liability of shareholders were unlimited shareholders would have to monitor each other in order to discover if other shareholders were transferring their assets in order to escape any potential liability. This argument didn’t hold true, even in the unsophisticated days of the 17th Century when the case of Salmon v The Hamborough Company was heard. In that case the shareholders of the unlimited liability company avoided their debts simply by failing to pay them and forcing the plaintiff to pursue them individually through the courts. If pursuing investors was practically impossible in the 17th century then it would be less likely now, given the increased numbers of shareholders in the modern

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466 Ibid
467 Ibid
468 Frank H Easterbrook and Daniel R Fischel, ‘Limited Liability and the Corporation’, as above, p95
469 Ibid
publicly listed corporation, making the need to monitor financial standing of other shareholders redundant.

If modern companies had unlimited liability potential plaintiffs seeking to recover damages would concentrate on pursuing substantial shareholders of the company. The risk of loss for small shareholders would remain insignificant. The risk to substantial shareholders would be greater. However, this increased risk would be appropriate because substantial shareholders have greater influence on appointing the boards of companies in which they hold shares. Substantial shareholders, therefore, have influence over the direction of the companies in which they hold shares. Substantial shareholders also have the means to avail themselves of substantial legal support and to defend themselves in any potential litigation. It seems ‘fair’ that shareholders, who have substantial shareholdings in a company, are able to influence the operations of a company and receive the larger share of dividends carry greater risks than small shareholders.

c) Limited liability, by promoting the free transfer of shares, gives managers incentives to act efficiently

This argument states that managers of companies will act efficiently, that is, act to make the company as profitable as possible, to keep share prices high. If managers don’t keep the share prices high the company will be taken over by other shareholders who will sack the management and install better management. There are two problems with this argument. Firstly it assumes that the share price is an indicator of a profitable and well run company. As share trading has become more and more speculative this is not always the case. Even if the share price represents a multiple of a company’s earnings, if shareholders are not monitoring management how can they determine whether the reported earnings are optimal for that company? Secondly, this argument ignores the reality that senior managements of companies are appointed by the boards of companies. Public company boards represent the interests of major shareholders. In other words, major shareholders already control senior management and sometimes are the senior management. The will therefore be unlikely to change the status quo by changing the management. For example, it would be highly unlikely for Rupert Murdoch (CEO of News Corp) or James Packer (CEO of publishing and Broadcasting Limited) to face the sack from their corporations.

\[470\] Ibid
d) Limited liability allows more efficient diversification

This argument states that limited liability allows investors to diversify their investment portfolios which allow firms to raise capital at a lower cost “because investors need not bear the special risk associated with nondiversified holdings.” This argument fails because there is nothing special about limited liability that allows investors to diversify their investment holdings.

An investor can diversify their investment portfolio irrespective of whether the investment has limited liability. For hundred of years the London based reinsurance company Lloyds sought ‘names’ to invest in reinsurance ventures. This investment carried unlimited liability. Even so, Lloyds had waiting lists of people ready and willing to invest. Many Lloyds’ names diversified their risk by investing in multiple reinsurance ventures.

Property investors, for example, may hold diversified real estate portfolios while retaining unlimited liability. In these cases the prudent property investor takes out insurance against potential loss.

e) Limited liability facilitates optimal investment decisions

This argument states that managers of limited liability companies can “maximize investors’ welfare by investing in any project with a positive net present value.” Managers would feel free to invest in projects that might otherwise be rejected as too risky because they know their investors have limited liability. This is a cavalier and unacceptable attitude to risk because it assumes that managers don’t have to concern themselves with any potential damage, to persons other than shareholders, their decisions could have. In his book the Corporation Joel Bakan even calls companies ‘externalising machines’. By this he means “all the bad things that happen to people and the environment as a result of corporations’ relentless and legally compelled pursuit of self-interest” are externalities, that is, other people’s problems.

471 Ibid, p96
472 Ibid
473 Ibid, p97
474 Ibid
475 Bakan J, The Corporation, as above, Chapter 3
476 Ibid, p61
One of the many appalling results of this type of ‘risk taking’ was the Ford Pinto case. In this case management made the optimal investment decision to build a car which was known to be liable to explode if hit in the rear because to stop the explosion would have cost about $11 per car. The company, rationally, decided that it would be to the company’s advantage, monetarily, for people to die rather than implement the change that would have saved lives.

Bakan lists the major legal breaches of “General Electric, the world’s largest corporation” between 1990 and 2001. Note, Bakan is only listing major breaches and of course only the breaches where General Electric was actually held to account. There is no way of knowing how often General Electric managed to escape getting caught for breaches of the law. The list is of 42 breaches of the law ranging from pollution offences, defrauding the government, safety violations and misleading consumers. Sanctions imposed against the company ranged from a fine of £2 billion for cleaning up asbestos pollution in the United Kingdom to a fine of $US11,000 “for violating worker safety rules in handling PCBs.” In many cases General Electric was not fined but ordered to clean up the environmental damage the company had caused. The fact that General Electric is a serial offender means that the cost-benefit analyses conducted by the management of General Electric must factor in the costs of getting caught in breaking the law. The competent accountants at General Electric must have calculated that the company makes a net benefit from breaking the law, even after factoring the legal costs of defending court actions and paying fines and costs when they lose the court actions.

2. Limited liability allows for perpetual succession

A standard corporate law text used throughout Australia, *Ford’s Principles of Corporations Law* offers only one reason for the existence/need of corporations. The 1,400-page text deals with the need for corporations in two sentences plus a 1765 quote from the eminent English jurist, Sir William Blackstone. The entire entry in the text is;

> Makers of law find it necessary to create artificial legal entities. By doing so they facilitate enjoyment of legal rights by continuing institutions and groups free from limitations imposed by human mortality.

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477 Ibid, p75
478 Ibid, pp75 to 79
479 Ibid, p78
480 Ibid, p76
481 Austin RP and Ramsay IM, *Ford’s Principles of Corporations Law*, as above, p31
482 Ibid
The Blackstone quote included in the text is:

As all personal rights die with the person; and as the necessary forms of investing a series of individuals, one after another, with the same individual rights, would be very inconvenient if not impracticable; it has been found necessary, when it is for the advantage of the public to have any particular rights kept on foot and continued, to constitute artificial persons, who may maintain a perpetual succession, and enjoy a kind of legal immortality. These artificial persons are called bodies politic, bodies corporate (corpora corporata), or corporations.\textsuperscript{483}

If legal immortality were all that was required in order to facilitate investment then the text overlooks many other forms of perpetual succession, for example government, religious bodies, trades unions (specifically banned from using the corporate form in Australia), members co-operatives (the former NRMA). This argument was thin even in 1765 when Blackstone was writing, because the laws of wills and succession operated then as now to pass property rights down the generations on death. The entire aim of wills and succession is to ensure that property rights do not die when the person owning the property dies. The text and Blackstone ignore other forms of perpetual succession that are available to investors that would ensure the continuation of productive activity ‘free from limitations imposed by human mortality’.

The Future of the Corporation

The features of large corporations described by Galbraith in the 1970’s are relevant today. The features of the large corporations include

1. The capital contributed by the original owners is negligible, “in each it could be paid off by a few hours’ or a few days’ earnings.”\textsuperscript{484}
2. The disenfranchisement of the shareholders.\textsuperscript{485} In very few instances, such as News Corporation, Microsoft, CNN, do individual shareholders have any power.
3. Influence in the markets in which it buys materials, components and labour; “the power of a monopsony”\textsuperscript{486}.
4. Influence in the markets where it sells its finished products; the power of monopoly\textsuperscript{487}.

\textsuperscript{483} Ibid
\textsuperscript{485} Ibid, p76
\textsuperscript{486} Ibid
Australia is a modern democratic industrialised nation. Australian residents take for granted the public capital that provides drinking water, electricity, sewerage works, telecommunications, schools, hospitals and road and rail infrastructure that are provided by the modern state. Even though these public capital goods are increasingly being privatised they were provided by the state and, when privatised, are largely subsidised by the state in various ways.

However, there are private goods that we also take for granted, goods produced by the large privately owned corporations. The goods used by the author today, for example, were, the home and its contents, prescription drugs, a well-equipped kitchen supplied with goods from a supermarket, a motor vehicle, fuel, a privately owned toll road, a computer, books, the Internet, a café, a newspaper, a radio and a television. As Galbraith put it in *The Age of Uncertainty*,

> The large corporation is here to stay. Those who would break it up and confine its operations within national boundaries are at war with history and circumstance. People want large tasks performed – oil recovered from the North Sea, automobiles made by the million to use it. Large tasks require large organizations. That is how it is. \(^{488}\)

Galbraith is saying that large managerial bureaucracies are here to stay as they are necessary to provide the needs of our increasingly complex society. However, these large organisations don’t have to be privately owned limited liability corporations, but in our society they are – that is how it is.

Many large corporations are multinational, that is, they operate in many countries. Galbraith proposes that they be regulated by “multinational authority – government that is coordinate in scope with the corporations being regulated. The decline in national identity is paving the way for this solution. There is no danger, however, that it will come too soon. In Europe international authority is distantly in sight. Elsewhere it is not.” \(^{489}\)

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\(^{487}\) Ibid


\(^{489}\) Ibid
In the meantime for “national governments and national corporations the only answer is a strong framework of rules that align the exercise of corporate power with the public purpose. This is not an exercise in hope and prayer. It is one of the dominant trends of the times. What a corporation can do to air, water, landscape, truth and the health and safety of its customers and the public is far more carefully specified than it was a mere decade ago. Ralph Nader didn’t bring this regulation. The need brought Nader. It will continue.” 490

Bakan, in his work *The Corporation* concludes, “by the end of the century, the corporation had become the world’s dominant institution” 491. Bakan states that the corporation, an entirely legal construct, must “pursue, relentlessly and without exception, its own self-interest, regardless of the often harmful consequences it might cause to others.” 492 I agree. The corporation must act in the interests of its shareholders as this is the entire reason for the existence of a corporation. Even though the vast majority of shareholders have been effectively disenfranchised from any meaningful decision making in the corporations in which they hold shares they are secure in the knowledge that the directors will attempt to maximise the share price and or the dividends for shareholders. Shareholders can have this confidence because they are aware that their interests are closely aligned with the interests of the corporate decision-makers who often own large parcels of shares or who are compensated by stock options. Recently, however, this confidence has been shaken by the collapse of Enron and other high profile collapses where the shareholders were among the victims. 493 Even though shareholders were among the victims in the Enron case Enron collapsed because directors were inflating the company’s profits in order to inflate the share price and the dividends.

Bakan’s entire work argues that “the corporation is a pathological institution, a dangerous possessor of great power it wields over people and societies.” 494 In the pursuit of profits corporations routinely and regularly harm others, workers, consumers, communities and the environment. 495 These harms “tend to be viewed as inevitable and acceptable consequences of corporate activity – ‘externalities’ in the coolly technical jargon of economists.” 496 Every person can think of a number of ‘externalities’ created by corporations that were not inevitable and unacceptable. A number that come to mind are the pain and suffering caused

490 Ibid
491 Bakan J, *The Corporation*, as above, p139
492 Ibid, pp1-2
493 Ibid, p60
494 Ibid, p2
495 Ibid, p60
496 Ibid
by the Dalkon Shield, the environmental damage caused by the Exxon Valdez, the chemical spill in Bhopal India, nicotine induced lung cancer. Examples are not difficult to find.

Bakan’s book acknowledges that regulations have failed to keep pace with the illegal activities of corporations and that when they have they have been ineffective. Bakan then suggests that the only way that corporate power can be curbed/civilised is by the use of more regulation.

Easterbrook and Fischel, while extolling the economic efficiencies of the limited liability company, recognise that this efficiency comes at a cost of “corporations in some circumstances to externalise the cost of risky activities.” 497 The authors suggest that in order “to reduce this social cost of limited liability, courts have pierced the corporate veil in situations where the incentive to engage in excessively risky activities is greatest. Other legal rules, such as managerial liability, minimum capitalization requirements, and mandatory insurance, can also be understood as attempts to reduce the social costs of limited liability.” 498 Courts are more likely to ‘pierce the corporate veil’ only in cases of closely held corporations and are unlikely to “impose pass-through liability on the owners of publicly held corporations.” 499 What Gabaldon is saying here is that courts are less likely to go behind the corporate form and hold individual corporate shareholders, directors or senior executives personally liable in large corporations but do so in smaller tightly held/owned corporations.

The major problems with these solutions are that;

1. Injured parties would still bear the onerous and sometimes impossible burden of proving the damage came from the corporation and
2. If courts are only willing to impose personal liability in cases of smaller, closely held corporations then the damages caused by the larger corporations (those with the resources to cause the most damage and the resources to rectify the damage caused) will remain uncompensated.

**Moderating the Potential Negative Impact of the Limited Liability Corporation**

1. Replace Boards of Directors with Public Auditors

497 Frank H Easterbrook and Daniel R Fischel, ‘Limited Liability and the Corporation’, as above, p117
498 Ibid
499 Theresa A Gabaldon, ‘The lemonade stand: feminist and other reflections on the limited liability of corporate shareholders’, as above, p1400
Galbraith rejects the suggestion of putting representatives of various sectional interests, such as labour, minorities, women and the public onto company boards. Galbraith says that it appears to be “a dubious reform. Those members of the board of directors who do not participate in day-to-day management are, we have seen, without power. So accordingly will be the representatives of labor, consumers and the public who are added by this change.”

Instead Galbraith suggests boards of directors in large firms be abolished. “These would then be replaced a board of public auditors, which would keep out of management decisions but ensure the enforcement of public laws and regulations, report on matters of public interest, otherwise keep management honest and ratify or, in the event of inadequacy or failure, order changes in the top management command.”

Galbraith recognises that the shareholder in the modern corporation “is without power and without function” and not really represented by the modern board anyway. Replacing corporate boards of directors with public auditors is seen by critics as socialising the firm.

Galbraith responds to the criticism

You will ask who then will represent the stockholder. The answer is that no one does now. The shareholder in the modern large corporation is without power and without function. He (or she) is also obsolete. A further plausible development would be to pay off such functionless stockholders in bonds and have the dividends and capital gains accrue to the public. That, all will say, is socialism. It is so. But it is socialism after the fact. The great corporation, as it develops, takes power away from the owners, from the capitalists. The most profound tendency of the modern corporation, one that is rarely mentioned, is to socialize itself.

It socializes itself in two ways. It takes all the power from the owners – disenfranchises the capitalists. It also makes itself socially indispensable. We know that if a corporation is large enough, it can no longer be allowed to fail and go out of business. The recent history of Lockheed, Rolls-Royce, Penn Central and other eastern railroads in the United States, Krupp, British Leyland, British Chrysler affirms this point. All have been rescued or are being supported by government.”

Galbraith J K, *The Age of Uncertainty*, as above, pp277, 278

Ibid

Ibid

Ibid, p277
As the modern corporation becomes more socially indispensable, having public auditors overview those operations of a corporation makes sense, especially as government funding is increasingly used to underwrite corporate failure and corporate operations. In NSW, for example, the development in private/public partnerships for the provision of public infrastructure demonstrates how government is making the corporation socially indispensable. Private corporations are building and maintaining formerly public infrastructure and are, in return, being given licenses to earn money from the public who use the infrastructure. Written into the contracts between the state and the private corporation is an assurance to the private corporation that, should there be a danger of the corporation going broke, the public purse will prop up the profits of the private corporation. In NSW this happened in 2004 when the State Government had to step in and shore up the profits of the Central to Airport rail link. Just recently it was revealed that the cross-city tunnel was in danger of not giving the private corporation the income it had projected. Details of the contract between the NSW government and the private operator of the tunnel revealed that the government was obliged to funnel traffic into the tunnel. The government has agreed to funnel (private vehicular, fee paying) traffic into the tunnel by closing roads and narrowing a major alternative road\(^{504}\).

In Australia, public money also continues to be used to mitigate the effects of private corporate failures. In Australia, for example, in 2000 “the Federal Government provided $4 million to top up the entitlements of 342 workers at National Textiles, a Hunter Valley company of which Mr Howard’s (the Prime Minister at the time) brother was the non-executive chairman.”\(^{505}\) Another, larger example, of public money being used to mitigate the effects of private corporate failures is HIH. HIH was Australia’s largest insurance company, which collapsed in 2001. Shortly after the collapse, the then Minister for Financial Services, Joe Hockey, announced that the federal government would be “spending $640 million over the next four years to assist those people in hardship as a result if the collapse of HIH.”\(^{506}\)

Modern socialism is not the work of politicians or college professors. It is the accomplishment of corporation executives and those to whom they owe money. They are the cutting edge. They are the men who appear in Washington or Whitehall on the day when bankruptcy seems inevitable to ask the government to come in.\(^{507}\)

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\(^{504}\) Davies A, ‘Tunnel strategy: wait for it to fail’, *Sydney Morning Herald*, 18 November, 2005, p3

\(^{505}\) Starick P, “What’s the difference between these firms? Howard helped one but won’t answer phone for the other”, *The Advertiser*, Adelaide, 10 December 2004, p13


\(^{507}\) Galbraith J K, *The Age of Uncertainty*, as above, p278
Even Galbraith, if indirectly, agrees that this ‘socialism’ is really a social handout or social welfare and the not the nationalisation of the corporation in any real sense. That is, it is not the state taking ownership of the corporate factors of production.

2. Human Actors to be prosecuted for Corporate Violations

Glasbeek suggests that each time corporations are caught violating the law, such as, trading while insolvent, causing environmental damage, failing to heed occupational health and safety laws, or product safety laws, etc then the “senior executives who exercised control over the operations of the violating corporation”\textsuperscript{508} should be personally prosecuted. Glasbeek believes that this would encourage responsible behaviour by controlling executives and, act as a deterrent to unduly risky behaviour on the part of executives. Glasbeek also believes that holding executives personally responsible is fair considering that executives are the persons earning the “tangible rewards – such as increased bonuses and options”\textsuperscript{509} if the companies perform well.

3. Substantial Shareholders be prosecuted for Corporate Violations

In Australia, shareholders with a substantial holding in a corporation are defined by the \textit{Corporations Act 2000} as persons who have a relevant interest in “5\% or more of the total number of votes”\textsuperscript{510} in the corporation. Australian corporations’ legislation requires shareholders with substantial holdings to provide information about their holding to the relevant company\textsuperscript{511}. This is because the legislators recognise that “these people have inherent power that must be regulated to protect other corporate investors.”\textsuperscript{512} The legislation recognises that substantial shareholders are not “mere passive investors”\textsuperscript{513} but have influence in equity markets and therefore changes in their share ownership must be reported to the share market.\textsuperscript{514} Glasbeek contends that if the law recognises substantial shareholders as persons with influence over the corporation in which they hold their substantial shareholding it follows that they should also be held to account for corporate violations of the law. The other reason Glasbeek advances for lifting the corporate veil over substantial

\textsuperscript{508} Glasbeek H, \textit{Wealth by Stealth}, as above, p272
\textsuperscript{509} Ibid
\textsuperscript{510} Corporations Act 2001 (Cth), Section 9
\textsuperscript{511} Corporations Act 2001 (Cth), Chapter 6C
\textsuperscript{512} Ibid, p272 even though Glasbeek is referring to the Canadian share markets and Canadian Corporate legislation Australian legislation recognises also influence of ‘substantial shareholders’ on the equities market.
\textsuperscript{513} Ibid, p272
\textsuperscript{514} Ibid, pp272-273
shareholders is that they benefit substantially from the proceeds of any corporate conduct or misconduct.\textsuperscript{515}

The above recommendations do not dismantle the limited liability concept however they would operate to moderate the operations of limited liability companies and moderate the effects of losses caused by those companies operating outside the law.

The advantages and shortcomings of private corporations are well understood by the authors referred to in this chapter. Critics of modern corporations generally agree, if grudgingly in some cases, that western capitalist society needs the products of large capital aggregations as offered by private corporations. In order to overcome the shortcomings of private corporations the suggestions made include;

1. Increased corporate regulation (Galbraith and Bakan)
2. Mandatory insurance (Easterbrook, Fischel and Gabaldon)
3. Socialism (Galbraith)
4. Prosecuting human actors and substantial shareholders for corporate violations (Glasbeek)

These suggestions are either practically unworkable or politically unpalatable. A practical and palatable solution to the problem of the ‘externalising’ corporation is taxation. Knowing the advantages that corporations derive from the ‘gift’ of limited liability and their ability to externalise liabilities in the event of corporate failure the expectation would be that corporations and their shareholders ‘pay’ for these advantages through the taxation system. However, as is shown below, corporations and their shareholders in Australia actually receive tax advantages over the taxation of other taxpayers. The rate of corporations’ tax is lower than for individuals and, shareholders receive the benefits of dividend imputation.

**Tax Treatment of Corporations in Australia**

Australian corporations have been treated, for tax purposes, in almost exactly the same way as people. The differences in treatment are few and the differences that do exist tend to favour the treatment of corporations, or corporate shareholders, over the treatment of other individual taxpayers. For example, in Australia over the last forty years corporate tax rates have been lower than the top marginal rates for personal taxes and since 1987 company shareholders have enjoyed the benefits of dividend imputation.

\textsuperscript{515} Ibid, p273
Comparing Corporate Tax Rates with Personal Income Tax Rates

Wage and salary taxes – “Australia’s top marginal tax rate has decreased over the past 40 years from almost 70% (in 1965-66) to its current level of 48.5 per cent (including the Medicare levy).”\(^{516}\) This was written in 2003 and since then Australia’s top marginal tax rate has fallen again to 46.5 percent for the tax year 2007-08.\(^{517}\)

Corporation Taxes – Australian corporate tax rates rose from 38% in 1959-60\(^ {518}\) to a high of 49 per cent in 1987\(^ {519}\). Since then the corporate tax rate dropped to 30% from 1 July, 2001 to the present day. In 1987 dividend imputation was introduced and remains.

Rates of tax have decreased in Australia over the past forty years; however, the feature that has remained constant is the fact that corporate tax rates are consistently less than the highest marginal personal tax rates. This tax rate differential provides a positive incentive to high income earners to minimise their tax burden by incorporating their enterprise. Dividend imputation is a way of company shareholders getting the benefits of separate corporate personhood without having to pay any tax for that benefit on distributed profits.

The ITAA97 provides for little difference in the way that individuals conducting a business are treated from the way in which companies are treated.

The only major differences between companies and individuals, is in the rate of tax imposed. The rates of tax payable are imposed by the Income Tax Rates Act 1986 (ITRA). For the year ended 30 June 2008 the rate of tax payable by resident individuals\(^ {520}\) is:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax on this Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 to $6,000</td>
<td>nil</td>
</tr>
<tr>
<td>$6,001 to $30,000</td>
<td>15% of each $1 over $6,000</td>
</tr>
<tr>
<td>$30,001 to $75,000</td>
<td>$3,600 plus 30% of each $1 over $30,000</td>
</tr>
<tr>
<td>$75,001 to $150,000</td>
<td>$17,100 plus 40% of each $1 over $75,000</td>
</tr>
<tr>
<td>$150,001 and over</td>
<td>$47,100 plus 45% of each $1 over $150,000</td>
</tr>
</tbody>
</table>

The core difference in the treatment of companies for income tax purposes from the treatment of individuals for income tax purposes is in the rates of tax charged as between

\(^{516}\) Commonwealth of Australia, *International Comparison of Australia’s Taxes*, published by the Commonwealth of Australia, 3 April 2003, p63
\(^{518}\) Commonwealth of Australia, *International Comparison of Australia’s Taxes*, as above, p140
\(^{519}\) Ibid, p141
\(^{520}\) ITRA s12(1): Sch 7, Part 1
individuals and companies. The company tax rate for the year ended 30 June 2004 was 30%. Companies enjoyed no tax free threshold, they pay a flat rate of tax instead of a progressive rate and, they pay a lower rate of tax than individuals do for all income over $52,000.

The other difference between the tax treatment of corporations and individuals is the advantage given to corporate investors by dividend imputation. Dividend imputation means that investors receiving a dividend from a corporation that has paid tax on corporate profits will receive the benefit of the tax paid by the corporation. That is, investors will, in effect, get a credit for the income tax already paid on their dividend by the corporation. The *Australian Master Tax Guide* explains,

> The core of the imputation system is the attachment of tax credits to distributions paid by corporate tax entities (called “franking”) in order to pass on to members the benefit of the tax paid at the corporate tax entity level.

**Illustrations of Dividend Imputation**

The following are illustrations on how, in a practical way, dividend imputation works to provide an advantage to company shareholders in the treatment of dividend income over individual taxpayers who do not receive dividend income.

**Illustration 1**

An individual taxpayer has received a dividend cheque for $7,000 in the year ended 30 June 2008. Assume that this is the taxpayers’ only income and also assume that the company paying the dividend is paying a fully franked dividend. In other words the assumption is that the company paid tax at the full corporate tax rate of 30% on its distribution.

The taxpayer must declare in his tax return the dividend received ‘grossed up’ for the tax paid by the company, in other words, a gross dividend receipt of $10,000. The tax payable on income of $10,000 is:

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521 ITRA s23(2)
522 The exception to this is the treatment of capital gains tax between companies and individuals. Companies pay 30% tax on capital gains and individuals pay a top rate of 24.25% tax on capital gains. This is because individuals pay capital gains tax at a concessional rate of half the tax normally payable, including the Medicare levy.
524 Ibid, p137
Illustration 2

The same details as above, except that the individual receiving the dividend has other taxable income of $50,000. The grossed up income of this taxpayer is $60,000.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Rate</th>
<th>Total Tax Payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>$6,000</td>
<td>Nil</td>
<td>$600</td>
</tr>
<tr>
<td>$6,001 to $30,000</td>
<td>15%</td>
<td>$3,600</td>
</tr>
<tr>
<td>$30,001 to $60,000</td>
<td>30%</td>
<td>$9,000</td>
</tr>
<tr>
<td><strong>Total Tax Payable</strong></td>
<td></td>
<td><strong>$12,600</strong></td>
</tr>
</tbody>
</table>

Less; Tax paid by the company (that is, 30% of $10,000) $3,000

Refund Due to taxpayer $2,400

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The Corporate Threat to Capitalism

There have been a number of books published recently that ascribe problems in modern society to the rise of corporations.

Two books have recently been published that, independently of each other, predict the end of capitalism unless corporate power is curtailed. Raymond Baker’s book, *Capitalism’s Achilles Heel*,525 propounds the view that the greatest threat to capitalism is the flow of ‘dirty money’ around the world, impoverishing nation states by depriving them of capital for private investment and taxation revenues for public investment. Baker identifies three types of dirty money as “criminal, corrupt and commercial.”526 Of the three types of dirty money by far the largest component comes from commercial money, that is, corporate money and “it is usually tax evading”.527 Tax evasion is considered in Chapter 6.

Michael Woodiwiss’ book, *Gangster Capitalism: The United States and the rise of organised crime*,528 propounds the view that United States style capitalism, which is

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525 Baker RW, *Capitalism’s Achilles Heel: Dirty money and how to renew the free-market system*, published by John Wiley & Sons, Inc., United States of America, 2005
526 Ibid, p23
527 Ibid
528 Woodiwiss M, *Gangster Capitalism: The United States and the rise of organised crime*, published by Constable & Robinson Ltd, United Kingdom, 2005
becoming world capitalism, is a threat to society because it is criminal capitalism. Woodiwiss states that global crime is not perpetrated in the main by the stereotype of gangster portrayed in film and book but by professionals and corporate officials. Woodiwiss states “Professional and corporate fraud has affected the health and financial security of millions of Americans, while gangster rip-offs affect a few. To take another comparison, the reckless and deceptive practices of executives in the tobacco and asbestos industries alone have caused the premature deaths of millions of innocent citizens, while the kill-rate of gangsters is relatively small.”

Woodiwiss implies that the corporate form allows large scale fraud and tax avoidance that threatens capitalism. When speaking of the founders of America’s corporate dynasties Woodiwiss states that although “decisions and responsibilities were concentrated at the top of corporate hierarchies, the complicated and fragmented new bureaucratic arrangements had the effect of making accountability for illegal or harmful activities more difficult. At the same time, the new impersonal corporations proved to be just as likely to put profit ahead of the health and safety of workers, communities and consumers as their founders.” The corporate vehicle protects the decision makers at the top of corporate hierarchies from illegal and damaging activities just as effectively today as it did in the period about which Woodiwiss is writing.

Baker estimates the amount of dirty money flowing across borders being in the range between $US1, 061 billion to $US1, 599 billion per annum. Of this total Baker estimates that 62.5% to 66% consists of commercial money. Baker believes that his estimates are conservative. To gauge the extent of damage caused by the flow of dirty money Baker has estimated that dirty money “coming illegally out of developing and transitional economies is about 8 per cent of their combined GDP.”

**Conclusion**

At the beginning of this chapter Tom Hadden was quoted as saying that the existence of companies is justified as underpinning the western model of capitalism even though “the ownership and control of business enterprises, and the distribution of profits arising in them, can be structured in any number of ways.” No reasons are advanced by Haddon or other

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529 Ibid, p4
530 Ibid
531 Ibid
532 Baker RW, *Capitalism’s Achilles Heel*, as above, p172
533 Ibid
534 Hadden T, *Company Law and Capitalism*, as above, p4
writers on company law as to why other ways of advancing capitalism have not been explored. Haddon was writing in the 1970’s and since that time company law commentators have become even more briefer about why the company form, in particular, is required to organise the production and distribution of goods and services in western capitalist economies. A prominent Australian politician was not so reticent. Peter Costello, unknowingly paraphrasing Gilbert and Sullivan 99 years later was direct and to the point, “(t)he whole concept of the corporation is to limit the liability of persons who subscribe money or who control money in a collective enterprise”\footnote{Costello P, ‘Is the Corporations Law Working?’ (1992) Vol 2 No 1 Australian Journal of Corporate Law 12- 19 at 17}

Owners and controllers of corporations constantly abuse this gift of incorporation – limited liability. Not only do owners and controllers abuse the gift, they are allowed to do so at preferential tax rates.
Chapter 5 Corporate Welfare

Introduction

The preceding chapter illustrated the fact that the major benefit of incorporation is limited liability and that this financial benefit is not paid for by companies via any discrimination in tax system. In fact the company rate of taxation is far less than the highest marginal rate of tax paid by individuals, 30% as opposed to 46%. In addition to the considerable benefit of limited liability, companies in Australia also receive substantial welfare payments from all levels of Australian government. This chapter will examine the types of corporate welfare made in Australia and try to evaluate whether or not the Australian people are getting good value for their money.

Normally, the concept of welfare relates to individuals, that is, real people, and not to the legal construct that is a corporation. Welfare is defined in an Australian legal dictionary (as opposed to a more generalist or humanist type of source) as “a state of well being; having one’s needs satisfied; happiness.” None of the elements of this definition applies to corporations; they have no feelings or needs, yet they are provided with ‘welfare’. The fact that organisations that exist primarily to make profits for private individuals receive substantial welfare from governments means that government and their constituents must believe that there is a social good from this use of public resources. This social good will also be examined in this chapter.

Corporate welfare in Australia is a substantial government expense. A Background Briefing on ABC Radio National on 30 June 2002 estimated that “(a)ll up, between Federal, State, Territory and Local Governments, it’s estimated that around 14 billion tax-payer dollars a year are spent propping up business in Australia.” Compare this to the amount of money the Federal Government spent on unemployment benefits (Newstart Allowance) in 2002-3 of $4.8 billion and on the aged pension of $17.7 billion.

The types of government welfare to industry are “direct handouts, interest free loans, land grants, tariff protection, tax exemptions, preferential tax rates, and even government agencies

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536 Nygh PE and Butt P (eds), Butterworths Australian Legal Dictionary, published by Butterworths, Australia, 1997, p1264
Another form of corporate welfare not easily quantifiable, and so not measured, is when corporations use the tax benefits system to “replenish low incomes from employment and at the same time save on support payments for the unemployed. In other words, the low wage strategy of employers will be legitimated and subsidised by the state, the acceptable face of corporate welfare replacing social welfare.”

Defining Corporate Welfare

The first use of the term corporate welfare was as a pejorative by Ralph Nader (US consumer activist) in 1959. In the introduction to his pamphlet Cutting Corporate Welfare, published in 2000 Nader defines corporate welfare as “the enormous and myriad subsidies, bailouts, giveaways, tax loopholes, debt revocations, loan guarantees, discounted insurances and other benefits conferred by government on business.”

Nader continues to say that corporate welfare “is a function of political corruption … (which) siphon funds from appropriate public investments, subsidize companies ripping minerals from federal lands, enable pharmaceutical companies to gouge consumers, perpetuate anti-competitive oligopolistic markets, injure our national security, and weaken our democracy.” Voters, including Australian voters, do not see corporate welfare as a corruption of the political process or as a weakening of democracy otherwise they would not support the provision of corporate welfare. Arguments to counter Nader would include that the provision of corporate welfare improves an economy by ensuring the viability of industry and sustaining and/or improving employment.

In 1998, the Australian Commonwealth government, recognising the importance of assistance to industry (corporate welfare), established the Productivity Commission (‘the Commission’). The Commission’s first function was “to hold enquiries and report to the Minister about matters relating to industry, industry development and productivity”. The Productivity Commission Act 1998 (Cth) goes on to define ‘matters relating to industry’ to include “any legislative or administrative action to be taken, by the Commonwealth, a State

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539 Tooth G, producer, Welfare for Business, on ABC Radio National, as above, pp2, 3
540 Whitfield D, Public Services or Corporate Welfare: Rethinking the Nation State in the Global Economy, published by Pluto Press, London and Sterling, Virginia, 2001, p8
542 Ibid, p 13
543 Ibid
544 Productivity Commission Act 1998 (Cth), s6(1)(a)
or a Territory that affects or might affect the productivity performance of industry.”\textsuperscript{545} The Commission must produce an annual report that must, “as far as practicable, report on assistance and regulations affecting industry and the effect of such assistance and regulations on industry and on the economy as a whole.”\textsuperscript{546} The Act goes on to define assistance.

S10(6) In this section:

assistance includes any act that, directly or indirectly:
(a) assists a person to carry on a business or activity; or
(b) confers a pecuniary benefit on, or results in a pecuniary benefit accruing to, a person in respect of carrying on a business or activity.

The Commission, in its last annual report, elaborated on the statutory definition and stated that

Assistance thus takes many forms. It extends beyond direct government subsidies targeted to particular firms or particular industries, and included tariffs, quotas, anti-dumping duties and regulatory restrictions on imported goods and services, as well as tax concessions and subsidies for domestic producers. Assistance also arises from the provision of underpriced services by government agencies and from government procurement policies.\textsuperscript{547}

The Productivity Commission Act 1998 (Cth) defines assistance as any act or pecuniary benefit that accrues to a person carrying on a business or activity. The Productivity Commission however, talks of assistance to firms or industries. The vast majority of actual assistance goes to companies and therefore to assisting company profits. Of course the profits may eventually be distributed to persons, but the actual assistance goes to companies. The Commission defines industry as “traditional goods industries such as agriculture, manufacturing and mining, as well as others such as retailing, banking, construction, tourism and the arts. Non-profit activities, such as charities and welfare services are excluded.”\textsuperscript{548}

The Productivity Commission recognises that the definition of assistance is very broad and “could be seen as implying that the general business of government - providing a legal

\textsuperscript{545} Productivity Commission Act 1998 (Cth), s6(2)
\textsuperscript{546} Productivity Commission Act 1998 (Cth), s10(3)
\textsuperscript{548} Industry Commission, State, Territory and Local Government Assistance to Industry Report No: 55, published by the Commonwealth of Australia, Canberra, 1996, p3 (Note the Industry Commission was the predecessor of the now Productivity Commission)
framework, a court system, police, defence, the purchase of stationary, and even welfare – indirectly assists a person or organisation to carry on a business or activity.”\(^{549}\) The Commission recognises that “the general business of government, while crucial to business and economic development, is not commonly regarded as assistance to industry.”\(^{550}\) The Commission therefore excludes such activities of government from their definition of industry assistance, as do I for the purposes of this discussion. However, as will be shown, these functions of government are actually the best way to attract and retain industry to a country.

A range of protectionist measures “have become ingrained in the economic fabric of the industrialized market economies since World War 11.”\(^{551}\)

I define corporate welfare, not pejoratively, but neutrally and descriptively, thus

Corporate welfare is all government assistance provided to industry whether by way of direct payments or indirectly in such as way as to provide a pecuniary benefit.

Three categories of corporate welfare have been identified\(^{552}\):

1. Direct financial assistance, which includes cash in the form of subsidies and bounties, grants, loans, tax concessions and government purchasing preferences.
2. In-kind assistance, which includes the provision or discounting of land and infrastructure requirements, planning advice and information and, the facilitation of approvals and access to government.
3. Direct protection of existing industries from imports by the use of tariffs and quotas.

**Types of Corporate Welfare**

In his book *The Myth of Free Trade, Patterns of Protectionism Since 1945*, Shutt provided the most exhaustive list (yet discovered by me) of direct financial assistance that governments provide to corporations. This list is reproduced below and then examined in the Australian context.\(^{553}\) Governments in Australia use all of the ways of providing corporate welfare that Shutt listed. Shutt confined his list to direct financial assistance provided by

\(^{549}\) Ibid
\(^{550}\) Ibid
\(^{552}\) Baragwanath C and Howe J, *Corporate Welfare: Public Accountability for Industry Assistance*, Discussion Paper No. 34, published by The Australia Institute, October, 2000, pp7 & 8
\(^{553}\) Shutt H, *The Myth of Free Trade, Patterns of Protectionism Since 1945*, as above, pp64-88
government and did not include the other forms of government assistance, that is, in-kind assistance and direct protection assistance that I have included.

1) Direct Financial Assistance
   - Tax concessions
   - Subsidised credit
   - Lenders of last resort
   - Direct grants
   - Equity participation
   - Nationalisation and complete State control of enterprises
   - Research and development support
   - Regional support
   - Discriminatory government procurement
   - Subsidisation of inputs
   - Labour subsidies

2) In-kind Assistance
   - Government bodies to support industry groups
   - Land
   - Government economic missions

3) Direct Protection
   - Tariffs
   - Import restrictions

Tax Concessions

The most basic and more or less universally practiced form of direct subsidy is tax concessions. The most universal tax concession is allowing for the depreciation of virtually all company fixed assets, other than real estate, against company profits\textsuperscript{554}.

A problem with tax concessions, according to Shutt, is that they are “a blunt instrument”\textsuperscript{555}. Tax concessions treat companies with formal equality. That is, they provide concessions to industries and firms that may be inefficient and/or operating in sunset industries as well as those that are efficient, profitable and operating in emerging or sunrise industries.

\textsuperscript{554} Ibid, p65
\textsuperscript{555} Ibid
The Australian government, for example, provides tax concessions for research and development expenditure, “which allows companies to deduct up to 125% of qualifying expenditure incurred on R & D expenditure activities when lodging their corporate tax return.”\textsuperscript{556} The government also offers a “175% Incremental (Premium) Tax Concession”\textsuperscript{557} for R & D expenditure in certain circumstances. The Productivity Commission report of 2004 reports the cost of Commonwealth tax exemptions as follows:

<table>
<thead>
<tr>
<th>Industry</th>
<th>2003-04 $m</th>
<th>2004-05 $m\textsuperscript{558}</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Production\textsuperscript{559}</td>
<td>514.8</td>
<td>525.6</td>
</tr>
<tr>
<td>Mining Sector\textsuperscript{560}</td>
<td>28.2</td>
<td>33.7</td>
</tr>
<tr>
<td>Manufacturing Sector\textsuperscript{561}</td>
<td>1001.6</td>
<td>1043.0</td>
</tr>
<tr>
<td>Services Sector\textsuperscript{562}</td>
<td>278.9</td>
<td>267.0</td>
</tr>
<tr>
<td>Unallocated\textsuperscript{563}</td>
<td>158.0</td>
<td>128.0</td>
</tr>
<tr>
<td><strong>Total Tax Expenditures</strong></td>
<td><strong>1981.5</strong></td>
<td><strong>1997.3</strong></td>
</tr>
</tbody>
</table>

Subsidised Credit

Subsidised credit consists of loans at subsidised rates of interest, or loan guarantees offered to businesses by governments. In Britain the Thatcher government established a “Loan Guarantee Scheme for small business.”\textsuperscript{564} In the United States “guaranteed loans to small enterprises have long been an established part of the US scene. In addition the US federal government has also been forced to succumb at various times to pressures for assistance to very much larger companies. However, this has usually been accorded not by way of providing a stimulus to new investment but rather in cases where a corporate collapse has threatened either a major financial crisis or serious social consequences or both”\textsuperscript{565}. After Shutt wrote this, the Savings and Loans debacle cost the US taxpayers $US125 billion\textsuperscript{566}.

\textsuperscript{556} Ausindustry, \textit{Grow your small business}, \url{http://www.ausindustry.gov.au}.
\textsuperscript{557} Ibid.
\textsuperscript{558} The 2003-04 data are budget estimates and the 2004-05 data are budget appropriations.
\textsuperscript{560} Ibid, pA10.
\textsuperscript{561} Ibid, pA17.
\textsuperscript{562} Ibid, pA24.
\textsuperscript{563} Ibid, pA26.
\textsuperscript{564} Shutt H, \textit{The Myth of Free Trade, Patterns of Protectionism Since 1945}, as above, p68.
\textsuperscript{565} Ibid.
In Australia the New South Wales (‘NSW’) government established a bank, the Rural Bank, in 1921 with the primary object “to afford greater assistance to primary producers than was usually obtainable from other institutions, and thus to promote rural settlement and development.”567 The New South Wales government now gives assistance to the rural community by way of its NSW Rural Assistance Authority. Of the types of assistance available are a special conservation loan scheme, natural disaster loans and interest rate subsidies for farmers in exceptional circumstances.568

Lenders of Last Resort

Since the Second World War most developed world governments have underwritten the finances of the corporate world “by the assumption by central banks of the role of ‘lenders of last resort’ to the banking industry.”569 This is the case in Australia where the Australian central bank, the Reserve Bank, acts as a lender of last resort to the Australian banking industry. The fact that the State provides lender of last resort to private corporations encourages the type of moral hazard encouraged by limited liability. Why should a lending corporation, competing for loans business, apply stringent credit standards, at the risk of not writing the loan and earning the interest, if losses will be covered by the State? In 1999 the Assistant Governor of the Reserve Bank of Australia, John Laker said

the costs of resolving financial crises can be substantial. The public purse bears the cost of government expenditure to recapitalise financial institutions and protect depositors. Asia may be freshest in our minds, but it is salutary to remember that, over the last twenty years, some 19 countries had to devote more than 10 per cent of GDP to the resolution of financial crises. Not all were emerging economies – two industrial countries (Japan and Spain) are on the list.570

Direct Grants

Direct grants are grants of cash given to firms by governments. They are given to pursue government policies, for example, cash given to manufacturer for research and development. Cash is also given to subsidise the profits of private companies so that they will remain in

569 Shutt H, The Myth of Free Trade, Patterns of Protectionism Since 1945, as above, p68
situ. For example, in May 2004 the Federal Government announced $50 million assistance for the Mitsubishi Motor Corporation\(^{571}\) to persuade it to keep manufacturing cars in Australia. In Australia, State and Commonwealth governments have hundreds of programmes and agencies to give cash to private companies for various reasons. “The discretionary use of grants is a weapon at the disposal of most OECD governments and one which is particularly vital in the competition for ‘footloose’ investment by multi-nationals. Although it is frequently denied that such competitive bidding between governments occurs – still more that the multi-nationals solicit it – both commonsense and available evidence indicate the contrary.”\(^{572}\) In Australia the Commonwealth and State governments compete with the governments of other countries to attract investment to Australia. In Australia we also have State and Territory governments competing with each other in order to attract investment.

In Australia the Productivity Commission (formerly the Industry Commission) reports annually on Federal government grants given to industry. The Productivity Commission also reported on State, Territory and Local government assistance to industry in 1996. The Productivity Commission report of 2004, the latest available, reports the cost of Commonwealth direct financial assistance as follows:

<table>
<thead>
<tr>
<th>Industry</th>
<th>2003-04</th>
<th>2004-05(^{573})</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
</tr>
<tr>
<td>Primary Production(^{574})</td>
<td>644.7</td>
<td>770.5</td>
</tr>
<tr>
<td>Mining Sector(^{575})</td>
<td>89.1</td>
<td>119.1</td>
</tr>
<tr>
<td>Manufacturing Sector(^{576})</td>
<td>779.3</td>
<td>854.4</td>
</tr>
<tr>
<td>Services Sector(^{577})</td>
<td>514.2</td>
<td>608.7</td>
</tr>
<tr>
<td>Unallocated(^{578})</td>
<td>259.0</td>
<td>269.6</td>
</tr>
<tr>
<td><strong>Total Outlays</strong></td>
<td><strong>2286.3</strong></td>
<td><strong>2622.3</strong></td>
</tr>
</tbody>
</table>

The direct financial assistance given by the Commonwealth to industry consists of both direct grants to firms and industries and funding to institutions, government and privately owned who are also charged with assisting industry in some way. For example, the CSIRO, a


\(^{572}\) Shutt H, *The Myth of Free Trade, Patterns of Protectionism Since 1945*, as above, p70

\(^{573}\) The 2003-04 data are budget estimates and the 2004-05 data are budget appropriations.


\(^{575}\) Ibid, pA10

\(^{576}\) Ibid, pA17

\(^{577}\) Ibid, pA24

\(^{578}\) Ibid, pA26
wholly owned commonwealth government research institute was granted $22.3million funding for research into mining in 2003-04. The Commonwealth also funded co-operative research centres in the amount of $16.2million for research into mining in 2003-04.

Equity Participation

Equity participation is when governments choose “to support investment projects by means of equity participation. This approach, which may be regarded as half way between a loan and a grant, can imply various possible purposes on the part of the government concerned.”

Government equity participation “is usually imposed for political reasons … (yet) … it often has attraction for foreign investors, since it has the simultaneous effect of reducing their own financial outlay on any investment project and of ensuring government commitment to the project.”

In Australia, for example, the Tasmanian government invested in a textile company in order to prevent its collapse. In 2000 the company National Textiles collapsed and the Federal government provided $7 million to help pay employee entitlements. Out of the collapse a private company, Australian Weaving Mills emerged. The owners of Australian Weaving Mills were Phillip Bart (51% ownership), former majority shareholder of National Textiles, and the Tasmanian Government (with 49% ownership). In 2004 Bart negotiated with the Tasmanian government for their share of the company, pledging to safeguard jobs in return for the shares. Bart then raised capital from private investors and remains with a 90% interest in the company. The Tasmanian government invested $8 million to keep the company operational and retains this exposure in the company. In order to keep the company operational the Tasmanian government “has lent its weight to Mr Bart’s push for more subsidies through the Federal Government’s Structural Investment Program to further upgrade plant and equipment.”

Nationalisation and Complete State Control of Enterprises

Nationalisation and complete state control of enterprises is not normally an indication of any socialist ideology, it is normally an indicator of governments stepping in to maintain the existence of bankrupt private sector companies, allowing them “to collapse into the arms of

579 Ibid, pA13
580 Ibid
581 Shutt H, The Myth of Free Trade, Patterns of Protectionism Since 1945, as above, p71
582 Ibid, p72
583 Robins B, ‘Rag-trade king seeks government aid’, Sydney Morning Herald, 3 September, 2004
the state.”  “In macroeconomic terms such unprofitable operations of the nationalized sector clearly need to be considered as an extension of government fiscal policy.”

The governments of Australia, just after World War II, “owned an uncommonly large part of the Australian economy.” “A full listing of these owned assets would be extensive” and included the “Commonwealth Aluminium Company, now known as Comalco” (now privatised), as well as shopping malls and factories. Since the 1980’s in “the developed OECD countries, privatisation of publicly owned enterprises took place on a large scale, beginning with the sale by public float of British Telecom, … in the United Kingdom in 1985.” In Australia the Federal Government stills holds on to a majority interest in Telecom but “is now poised to sell its last interests in the telephonic industry.” Quiggan notes that the trend to privatisation “clearly slowed”. “For the first time in decades, nationalisation or renationalisation has taken place on a significant scale. Notable examples include the nationalisation of airport security in the United States, the effective renationalisation of the railway system owner Railtrack in the United Kingdom and the establishment of a new publicly-owned bank in New Zealand.”

“In Australia, the (then) Minister for Small Business, Joe Hockey, recently suggested that it might be necessary for State governments to re-enter the insurance business following the collapse of HIH Insurance and United Medical Protection.” This is an example of a minister in a conservative government proposing government ownership of an enterprise when the free-market fails.

Research and Development Support

Government support of research and development (R&D) is by the provision of generous tax concessions, grants and government organisations undertaking R&D. Another important government protection provided for new R&D is intellectual property and patent laws. The

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584 Shutt H, *The Myth of Free Trade, Patterns of Protectionism Since 1945*, as above, p74
585 Ibid
586 Harris AC, ‘Debate on public or private ownership’, presented at the Australian National Infrastructure Forum at the Sydney Convention Centre on 17 March, 1998, p1. At the time Harris was the NSW Auditor-General.
587 Ibid
588 Ibid
589 Ibid
591 Harris AC, ‘Debate on public or private ownership’, as above, p1
592 Quiggin J, ‘Privatisation and nationalisation in the 21st century’, as above
593 Ibid
594 Ibid
Organisation for Economic Co-operation and Development (OECD) recognises that “science, technology and innovation have become key factors contributing to growth in both advanced and developing economies.”

The OECD reported that in 2005 “18 OECD countries have tax incentives in place compared to only 12 in 1996.” Australia is one of the countries offering tax incentives to private firms undertaking research and development. Australia also provides government owned and funded research organisations to undertake research for private companies. The largest of these research organisations is the CSIRO. At June 1995 the CSIRO employed 6,576 people across 57 sites in Australia and overseas, and it received government funding of $577 million.

Regional Policy

Regional policy is where states and regions in a country, or country grouping like the EEC, compete to provide incentives for private investment in order to attract that investment. Shutt describes regional policy as “arguably the most irrational of all the manifestations of official resistance to market forces – for all its socially creditable motives”. Shutt notes that in the United States “the individual states have traditionally played a bigger role in providing incentives for private investment than has the federal government. Indeed the scale of confusion and self-defeating competition is all the greater because local authorities as well as national governments can and do influence the overall pattern of policy on regional development, often without there being any mechanism for coordination of the different regions’ promotional efforts either with each other or (if such exist) with the national government’s industrial or regional strategies.” Although Shutt wrote this twenty years ago about the United States the statement accurately reflects the situation in Australia and the Australian states’ approach to regional assistance and development.

Direct cost subsidies to encourage regional development is not generally “about stimulating investment in strategic or potentially expanding sectors of the economy, but about shielding declining industries in uneconomic locations from the harsh logic of market forces.” Australian examples of this type of aid are the propping up of motor vehicle manufacturing.

596 Ibid, p36
598 Shutt H, The Myth of Free Trade, Patterns of Protectionism Since 1945, as above, p78
599 Ibid, pp78-79
600 Ibid, p80
in South Australia and the government support of a textile firm in Tasmania. The impact of regional policy in Australia is discussed later in this chapter under the heading, ‘the Prisoners’ Dilemma of State Corporate Welfare’.

Discriminatory Government Procurement

Government procurement of goods and services is “the most widespread and convenient of subsidy mechanisms”\(^{601}\). “The most conspicuous application of subsidy through procurement has been in the military field. Because of the connection with national security it has long been accepted that military procurement cannot be conducted on the basis of free international competition.”\(^{602}\)

“Governments are anxious to offset the often heavy but unavoidable budgetary burden to the maximum extent possible by seeking non-military applications with which to capitalize on the research and development costs incurred in defence programmes. The companies which benefit from this ‘spin off’ thus enjoy a de facto subsidy – whether or not they have been directly involved in the original military contract – in so far as they are enabled to exploit for civilian use plant or technology whose investment costs have been largely if not wholly written off under a state procurement programme.”\(^{603}\) A “striking illustration of this phenomenon is the fact that the most commercially successful jet airliner ever built – the Boeing 707 – was originally developed as the KC135 in-flight refuelling tanker for the US Air Force.”\(^{604}\)

The Australian federal government engages in discriminatory procurement in order to assist industry. The Department of Communications, Information Technology and the Arts (DCITA), for example, have a discriminatory procurement policy in place for small to medium enterprises (SMEs)\(^{605}\) in the information and communication technology (ICT) sector. The DCITA advertises its preferential procurement policies on its website in the following terms;

The Australian Government has in place a number of policies to facilitate the development of the ICT sector through Government procurement practices. The

\(^{601}\) Shutt H, The Myth of Free Trade, Patterns of Protectionism Since 1945, as above, p80
\(^{602}\) Ibid
\(^{603}\) Ibid, p81
\(^{604}\) Ibid
\(^{605}\) Department of Communications, Information Technology and the Arts, ‘Procurement and industry development’, http://www.dcita.gov.au/ict/, accessed on 1/3/06. SMEs for ICT purposes are defined as companies with an annual turnover of less than A$500 million, averaged over five years.
Government recognises that the public sector is a key market for many Australian industry SMEs, and a valuable means for demonstrating their credentials and experience. This can help them enter markets, both domestically and overseas.\textsuperscript{606}

The DCITA then lists the policies in place that advantage Australian SMEs in ICT. These policies include providing for SME participation of a minimum of 10\% of hardware and 20\% of software in all contracts valued over $20 million\textsuperscript{607}.

Subsidisation of Inputs

Governments can subsidise private company inputs by providing tax concessions, undercharging for the use of public utilities and or by setting “tariffs in such a way that domestic consumers effectively subsidise industrial ones.”\textsuperscript{608}

State governments in Australia routinely subsidise inputs of companies in order to attract regional development. In New South Wales for example, the Industry Assistance Fund was allocated $19.9 million in 1994-94 and $14.9 million in 1995-95\textsuperscript{609} These funds were used to put together assistance packages that typically consisted of “payroll tax rebates, stamp duty rebates, workforce training, provision of infrastructure, project facilitation and provision of information.”\textsuperscript{610}

The Industry Commission also found that in addition to tax revenue foregone and direct assistance given to companies via the Industry Assistance Fund there were “potentially a number of other non-tax revenue foregone measures that may be providing assistance to industry but for which no public information could be found. These include infrastructure concessions provided in respect of relocating/existing firms’ usage of water, electricity, rail and road inputs to their business operations.”\textsuperscript{611}

Labour Subsidies

Labour subsidies are provided to private companies so that minimum wages, and by extension living standards, are maintained while at the same time allowing “private

\textsuperscript{606} Ibid
\textsuperscript{607} Ibid
\textsuperscript{608} Shutt H, \textit{The Myth of Free Trade, Patterns of Protectionism Since 1945}, as above, p83
\textsuperscript{610} Ibid
\textsuperscript{611} Ibid, p150
employers to maintain their competitiveness and profitability.” Subsidising wages can take the form of a “direct state supplement to wages” and subsidising training programmes and training wages.

The Australian federal government operates a number of wage subsidy schemes. CRS Australia administers the Wage Subsidy Scheme (WSS) that encourages firms “to employ eligible workers with a disability under open employment conditions. It aims to improve the competitiveness of job seekers with a disability through the provision of a time limited once-off wage subsidy” paid to employers. The wage subsidy is a payment of $1,500 paid to the employer for each eligible employee employed for at least 13 weeks. Other wage subsidy schemes include subsidies paid to employers for employing long-term unemployed persons and unemployed Aboriginals or Torres Strait Islanders.

The subsidies are complex and varied, but all are one off payments made to the employers after the eligible person has been employed for 13 or 26 consecutive weeks. The wage subsidies for job seekers “depend on the length of the job seeker’s unemployment.” The subsidies for job seekers are

- $1,650 for an employee, who had been unemployed for 4 to 12 months. Payable after 13 weeks of consecutive employment and for sufficient hours “not to be in receipt of any Social Security Payments through Centrelink.”
- $3,300 for an employee, who had been unemployed for over 12 months. Payable after 13 weeks of consecutive employment and for sufficient hours “not to be in receipt of any Social Security Payments through Centrelink.”
- An additional $3,300 for an employee, who had been unemployed for over 12 months. Payable after a further 13 weeks of consecutive employment, that is for 26 weeks, and for sufficient hours “not to be in receipt of any Social Security Payments through Centrelink.”

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612 Shutt H, *The Myth of Free Trade, Patterns of Protectionism Since 1945*, as above, p85
613 Ibid, p86
614 A Commonwealth government agency, formerly called the Commonwealth Rehabilitation Service.
616 Ibid
618 Ibid
619 Ibid
620 Ibid
The above data comes from a private job search firm that uses the government subsidies to attract employers to their service. The information was not readily available from a government department. The total cost of employment subsidies was also not available.

In order not to be in receipt of any social security payments through Centrelink a person must satisfy an income and assets test. For example, in order to qualify for the Newstart allowance (unemployment benefit) a single person with no dependents must earn less than $662.71 per fortnight. An employer, could therefore, employ a previously unemployed person part-time for 13 weeks at $662.71 a fortnight and receive up to $3,300 from the government. The cost to the employer for the use of the employee would be just over $1,000. This would encourage employers to take on people for part-time work and for limited periods. This system would not encourage any long-term full-time job creation, nor would this subsidy scheme appreciably lift the living standards of the unemployed.

Government Agencies Providing Support Industry Groups

The Australian governments, state and federal, own and operate many government funded industry support agencies that provide different types of support at no direct cost to various industry sectors. The Commonwealth government Department of Industry, Tourism and Resources has as its mission to develop and administer “programs and services designed to advance Australia’s innovation and technology capabilities in manufacturing, resources and service industries.” Australian state and territory governments also run departments and programmes similar to that of the Commonwealth and duplicate the work of this Commonwealth department.

A recent initiative of the Department was to spend $180 million over three years on an advertising campaign designed to increase international tourism to Australia. The Federal Tourism Minister, Fran Bailey, announced “this is $180 million over three years that the Australian Government is investing in this industry.” In other words, the government is subsidising the private profits of tourism operators by advertising their products in the market.

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622 Calculated by taking the employee’s wages of $662.71 per fortnight, times 6.5, less the subsidy of $3,300, which equals $1,007.62.


Land

The Australian government has a long history of allowing private commercial interests to use public land for private profits. Imperial governments of the colonies that made up Australia granted pastoral leases to private interests over vast tracts of land in all of the original colonies that made up Australia. For example, the National Archives of Australia states that “during the late nineteenth century a substantial part of the (Northern) Territory was acquired by pastoralists under pastoral leases issued by the South Australian government, which administered the Northern Territory from 1870 to 1911.”625 In Australian law the term pastoral leases is defined “as a lease permitting the use of Crown lands for the purposes of grazing … and … may also include agricultural or other non-dominant uses essential to, carried out in conjunction with, or inseparable from, the pastoral enterprise”626. Pastoral leases “exist on around 44 percent of Australia’s land area in the arid and semi-arid areas and the tropical savannas.”627

In addition to the vast tracts of Crown lands used for private gain in the pastoral industry, land is also granted on favourable terms to other private corporations for other commercial purposes. Industrial estates are provided on favourable terms for industry and the cost of infrastructure heavily subsidised. For example, the Ministerial Budget Statement 2002-2003 for the Department of Transport and Regional Services announced a large range of government funded infrastructure projects for private industry. These projects, which improve the value of private industrial land, included

1. HiSmelt Technology - $125 million over three years to provide infrastructure for Rio Tinto in Western Australia,
2. Syngas Technology - $85 million over two years to provide infrastructure the Methanis Corporation in Western Australia,
3. Wodonga Rail Bypass and Freight Transfer Centre - $20 million over two years to provide freight rail infrastructure in the border region of NSW and Victoria,
4. Support for regional air services - $13 million of which $7 million will be spent on infrastructure and $6 million will be route charges from which regional airlines will be exempt,

626 Nygh PE and Butt P (eds), Butterworths Australian Legal Dictionary, as above, p855
5. Northern Mallee Pipeline – Stage 7 South - $4 million will be spent on a water pipeline for farmers in the Northern Mallee district⁶²⁸

Government Trade Missions

The Australian government runs a statutory authority, the Australian Trade Commission (‘Austrade’), within the department of Foreign Affairs and Trade. Austrade is “the Australian Government’s principal trade and international business facilitation agency.”⁶²⁹ Austrade’s primary strategy is to continue “to help established exporters grow their export businesses …and … help export-capable businesses that have never exported before or are relatively inexperienced exporters to become sustainable exporters.”⁶³⁰ The main way that Austrade does this is by holding trade fairs and conducting trade missions in Australia and principally overseas. Austrade is budgeted to cost the Australian government $308.3 million in 2004-05⁶³¹.

In addition to Austrade the various Australian states also engage in funding trade missions. For example, the West Australian government through its Department of Industry and Resources also “conducts international trade missions to key event and markets around the world”⁶³² specifically to promote West Australian companies.

In addition to Austrade the Australian government also sends ad hoc missions overseas to plead the case of Australian industry in particular cases. Two recent instances include

1. In February 2006, the Australian government sent a mission, headed by the Deputy Prime Minister Mark Vaile, to Iraq in order to “protect the interest of Australian wheat growers”⁶³³. This mission was sent in response to a scandal involving the Australian Wheat Board, a private, for profit, company and Australia’s sole marketer of wheat to the world.

2. In March 2006, the Australian government sent a mission, headed by the Federal Tourism Minister, Fran Bailey, to London to “defend the controversial $180million

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⁶³⁰ Ibid, p90
⁶³¹ Ibid
⁶³² Department of Industry and Resources (WA), ‘Export and Trade’, http://www.doir.wa.gov.au, accessed 14/03/06
‘bloody’ tourism ads” paid for by government to promote tourism in Australia and banned by British regulators from British television.

Tariff Assistance

Tariffs that are imposed on imported goods “increase the price at which those goods can be sold on the Australian market, and thus allow scope for domestic producers of similar products to increase their prices.” In other words, local producers of goods on which there are tariffs, are able to increase their profits. The Productivity Commission also states “on the other hand, tariffs also increase the price of goods that are used as inputs and thus penalise local industries.” However, the only local industries that are penalised are those attempting to export their products. If inputs are made more expensive by tariffs and those inputs are used to produce goods for sale exclusively in the Australian market, then the burden of tariffs is borne by the end consumer and is neutral to the profits of the producer. The Productivity Commission does not distinguish between tariffs on inputs that are borne by Australian consumers of goods and that borne by producers competing in world markets. The Productivity Commission therefore, overstates the negative impact of tariffs on Australian producers’ profits. In 2003-04 the “Commission estimates that the gross dollar value of tariff assistance on outputs, that is, assistance to local profits, was around $7.5 billion in 2003-04.” The Commission estimated that tariff input assistance, that is, tariffs that reduced local profits, in 2003-04 was

<table>
<thead>
<tr>
<th>Industry Sector</th>
<th>$ Million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Production</td>
<td>94.9</td>
</tr>
<tr>
<td>Mining</td>
<td>172.5</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>2,484.4</td>
</tr>
<tr>
<td>Services</td>
<td>2,763.9</td>
</tr>
</tbody>
</table>

A substantial proportion of input assistance in the primary production and mining sector would be applied to goods for export and would have adversely affected profits. However, the input assistance to the manufacturing and service sectors would have been applied to the production of domestically consumed goods and services and would therefore, have been profit neutral.

634 McPhedran I, ‘Writing on wall for ad’, The Courier-Mail, Brisbane, 15 March, 2006, p19
635 Productivity Commission Annual Report Series, Trade & Assistance Review 2003-04, as above, p2.8
636 Ibid
637 Ibid
Import Restrictions

Australia no longer uses import quotas to protect Australian industry from competition. The Automotive industry was the last to use quotas in Australia and these “were phased down from 20% in 1984 and abolished completely in 1988.”

Australia does use other forms of regulation and restrictions that have the same effect as import quotas. The most important of these is anti-dumping and countervailing activity. Anti-dumping activity consists of the government imposing measures, mainly temporary customs duties, being imposed on ‘dumped’ imports “if the imports cause, or threaten to cause material injury to the local industry.” “Dumping is said to occur when a foreign supplier exports goods at a price below the value of the goods in the supplier’s home market.” Anti dumping measures, would in my opinion, not constitute a form of corporate welfare. Countervailing activity on the other hand is where Australia imposes ‘countervailing duties’ on imports “where import – benefiting from certain forms of subsidies in the country of origin – cause, or threaten to cause, material injury to a domestic industry.” Most imports to Australia could benefit from some form of assistance in the country of origin, for example the use of government owned ports to facilitate exports, and therefore this activity could easily be seen as a form of corporate welfare. The Productivity Commission reports “the number of new anti-dumping and countervailing cases initiated in Australia has been stable and relatively low over recent years.” The Commission also reports that “lack of information means that the Commission does not include the assistance effect of these duties in its national estimates, but monitors year to year usage.” The Commission noted that “Australia, with 49 measures in force in 2002-03, was the eighth largest user of anti-dumping and countervailing duties” in the world.

Australia uses other regulations to limit international competition in Australia and protect Australian companies. A recent example when the Australian government, despite having signed a free trade agreement with Singapore, refused to allow Singapore Airlines to

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639 Productivity Commission Annual Report Series, Trade & Assistance Review 2003-04, as above, p2.11
640 Ibid
641 Ibid, pC.1
642 Ibid, p2.11
643 Ibid
644 Ibid, pC.3
compete with the Australian privately owned airline Qantas on air routes out of Australia to the United States of America.\textsuperscript{645}

Social Infrastructure

Shutt holds that “the entire apparatus of physical and social infrastructure – mostly financed out of public funds – constitutes an asset of which private companies can make profitable use, even though the community’s investment in it is generally undertaken for much broader reasons than consideration of potential economic or commercial gains to the corporate sector, whether public or private.”\textsuperscript{646} The types of social infrastructure in this category include the education system, the health system, and the provision of utilities, communication, the police force and the military, the courts and the democratic and stable political system.

Even though government provided infrastructure is of crucial importance to firms when making locational decisions I would not categorise its cost as being a form of corporate welfare. This is because the provision of social infrastructure is the duty of government for the enjoyment of its citizens.

The Amount of Corporate Welfare

Corporate welfare in Australia is delivered via a combination of direct financial assistance, in-kind assistance and by direct protection of existing industries from imports by the use of tariffs and quotas. The Australian government at the federal level imposes tariffs and quotas. All three levels of government, federal, state and local, provide the other forms of assistance.

Each year the Australian Productivity Commission produces an Annual Report that values the total Commonwealth government assistance to industry for the year. In 2003-04 the assistance provided by the Australian government was “estimated to be equivalent to over $11 billion in gross terms … Tariffs provided the equivalent of an estimated $7.5 billion of assistance … (and) … budgetary assistance totalled an estimated $4.3 billion”\textsuperscript{647}. The budgetary assistance included $2.3 billion of actual cash outlays plus $2 billion tax concessions.\textsuperscript{648}


\textsuperscript{646} Shutt H, The Myth of Free Trade, Patterns of Protectionism Since 1945, as above, p87

\textsuperscript{647} Industry Commission, State, Territory and Local Government Assistance to Industry Report No: 55, published by the Commonwealth of Australia, Canberra, 1996, p x

\textsuperscript{648} Ibid
The amount of corporate welfare provided by the states and territories and local government is not so easy to determine nor is it done on a regular basis. This is because these levels of government all record corporate welfare payments within the costs of individual government departments and do not aggregate the total cost of corporate welfare spending. The Industry Commission last reported on state, territory and local government assistance to industry in 1996. Using these figures budgetary assistance to industry from state, territory and local governments in 1995 was estimated at $5.8 billion. That is state, territory and local governments in 1995 provided $1.5 billion more direct budgetary welfare to the corporate sector than the Commonwealth government did nine years later in 2003-04.

Table 2

<table>
<thead>
<tr>
<th>State, Territory and Local Government Assistance to Industry</th>
<th>($ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>State and Territories budget (1994-94)</td>
<td>2,127&lt;sup&gt;649&lt;/sup&gt;</td>
</tr>
<tr>
<td>Local (1996 survey)</td>
<td>145&lt;sup&gt;650&lt;/sup&gt;</td>
</tr>
<tr>
<td>Cost of Administering assistance</td>
<td>370&lt;sup&gt;651&lt;/sup&gt;</td>
</tr>
<tr>
<td>State payroll tax exemptions (1993-94)</td>
<td>3,203&lt;sup&gt;652&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>Total Assistance</strong></td>
<td><strong>5,845</strong></td>
</tr>
</tbody>
</table>

In 2002 the “Productivity Commission chairman Gary Banks said that incentives paid by state governments to entice big business projects had increased by 20 per cent in real terms, and more than one-third in actual dollars, since the mid-1990’s.”<sup>653</sup> Therefore, if only the amounts actually paid by state governments increased by one-third, then the total assistance paid by state governments increased by $702 million ($2,127m x 33%) by 2002. If the other assistance increased by the same amount then the total increase in assistance to 2002 would have been $1,929 million ($5,548m x 33%). A rough estimate of total state assistance would be $7,774 million in 2002.

“Commonwealth assistance is provided mainly (two-thirds) by way of import tariffs and other forms of market protection.”<sup>654</sup> Not surprisingly, “State and local government

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<sup>649</sup> Ibid, p8  
<sup>650</sup> Ibid  
<sup>651</sup> Ibid, p12  
<sup>652</sup> Ibid, p8  
<sup>653</sup> Fraser A, ‘$3.3bn lost on luring companies’, *The Australian*, 7 November, 2002, p5  
assistance is provided predominantly by budget outlays and revenue foregone.”655 This is not surprising because State and local governments are constitutionally unable to interfere with free trade and commerce. The Productivity Commission argues that even the provision of State and local government budget outlays as corporate welfare may not be “in the spirit of the free trade and commerce provision of Section 92 of the Constitution.”656

What is surprising, given the smaller budgets of State and a local government is the fact that State and local governments provide more corporate welfare from their budgets than does the Commonwealth government. Commonwealth government budgetary assistance to industry in 2003-04 was estimated at $4.3 billion compared to an estimated Australia combined State and local government budgetary assistance of $7.8 billion in 2002.

Corporate Taxation compared to Corporate Welfare

A good taxation regime should promote equity, be cheap to administer, easy to understand and not lead to a gross distortion of resources. The Asprey Report of 1975, the most comprehensive review of the Australian taxation system since the Ferguson Commission report of 1932-1934657, stated that the aims of a good tax system were “efficiency, fairness and simplicity”658. The report described these goals as “the economic and efficient use of the resources of Australia … a fair distribution of the burden of taxation … and … by means that are not unduly complex and do not involve the public or the administration in undue difficulty, inconvenience or expense.”659 A recent submission660 into a Senate Inquiry into the Structure and Distributive Effects of the Australian Taxation System reiterated that the goal of fairness has been “fundamental principle of the Australian taxation system”661 in every government inquiry into the Australian taxation system since the release of the Asprey Report662.

The University of NSW faculty of law has as one of its research centres and programmes a ‘Social Justice Project’. The Social Justice Project specialises in

655 Ibid
656 Ibid, p xxix
658 Ibid, para 3.6
659 Ibid
660 Rider C and Stewart M, Submission to the Senate Economics Reference Committee; Inquiry into the Structure and Distributive Effects of the Australian Taxation System, Melbourne Law School, University of Melbourne, 17 April, 2003, p1
661 Ibid
662 Ibid
• Social welfare and social development, especially social security, welfare reform, and employment assistance
• Economic development and taxation, especially tax reform, financial regulation, and public investment and
• Governance and civil duty.\textsuperscript{663}

In other words, the University of NSW holds that taxation and welfare are both social justice issues and as taxation revenue funds welfare, among other government expenditures, I believe they are inextricably linked.

Tax and welfare are both ethical, social justice issues. Distributive justice issues apply as much to welfare as to tax, making the comparison between corporate tax paid and corporate welfare received and, corporate and individual welfare, a valid and reasonable exercise.

This is an attempt to gauge the magnitude of corporate welfare by comparing the amount of corporate welfare provided with the amount of revenue received by Australian governments from corporations.

All levels of government in Australia levy corporate taxation. Just as all levels of government distribute corporate welfare. The Commonwealth government levies the largest tax, income tax. The State governments levy payroll tax and land tax and local government levies taxes on land in the form of rates.

A myriad of other taxes are paid via corporations to the government, but are actually passed on by business and directly borne by the consumers. These taxes include the goods and services tax, sales tax, excise tax, taxes on gambling and taxes on insurance.

To estimate the amount of taxes paid by corporations I have included taxation revenue from the State and Commonwealth levels of government from 2002-03 as follows\textsuperscript{664}

\begin{center}
\begin{tabular}{|l|c|}
\hline
Income taxes levied on enterprises – Commonwealth & 38,696 \\
\hline
\end{tabular}
\end{center}

\textsuperscript{663} UNSW, \url{http://www.law.unsw.edu.au/centres/sjp/index.asp}, accessed 1/2/06
\textsuperscript{664} Australian Bureau of Statistics, \textit{2005 Year Book Australia}, published by the Commonwealth of Australia, 2005, p742
Payroll tax – State 9,874
Other employers’ labour force taxes – Commonwealth 3,020

Total 51,590

I have excluded taxes on immovable property because those taxes fall mainly on real estate, and individuals pay a large proportion of real estate taxes. On the other hand I have included all employer taxes even though individuals do run enterprises as sole traders or partnerships pay a proportion of these taxes.

Taking taxes paid by corporations as being estimated at $52 billion and corporate welfare received by corporations as being estimated at $18.7 billion, then corporations receive $1 back in welfare for every $2.80 they pay in taxes.

Difference between Corporate Welfare and Individual Welfare

Corporate welfare, like welfare to individuals, is distributed in many ways by all levels of government.

The differences between corporate welfare and welfare provided to individuals is that

- Corporate welfare is not subject to the same ‘mutual obligation’ from the recipient as is individual welfare.
- Corporate welfare is not subject to means testing of the recipient, as is individual welfare.
- Corporate welfare is not provided in as transparent a manner as is individual welfare. The reason given by governments is the need for commercial in confidence.
- Much corporate welfare is not quantified. Some forms of corporate welfare, for example, trade controls and credit restrictions are extremely difficult, if not impossible to quantify.

Mutual Obligation

Corporate welfare is not subject to the same ‘mutual obligation’ from the recipient as is individual welfare. People receiving the Newstart Allowance (unemployment benefit) must

665 $18.7 billion comes from adding Commonwealth welfare of $11 billion to State, Territory and local welfare of $7.7 billion as above.

comply with a raft of conditions in order to receive their benefit. Centrelink, the government department that pays and manages the Commonwealth Newstart Allowance has defined mutual obligation for people on Commonwealth benefits. “If you are looking for work, the Australian community supports you in many ways, for example by paying you income support, offering Centrelink self-help facilities and referral services. Mutual obligation is about you giving something back to the community that supports you.”\(^{667}\)

Centrelink goes on to provide a list of classes of people who are exempt from mutual obligation, those who are:

- eligible for the Personal Support Programme
- in full-time education
- ill for an extended period
- required to care for another person or child
- living more than 90 minutes from an activity… or,
- exempt from job search activities for other reasons.\(^{668}\)

All other Newstart allowance recipients for over six months and aged between 18 to 49 years “must participate in extra activities”\(^{669}\) in order to continue receiving the allowance. To meet the mutual obligation requirements an individual must participate in one or a combination of “employment and community participation, training, and assistance programmes.”\(^{670}\) Participation is not optional and the amount of participation is proscribed in great detail. The government also makes participation in the activities “your responsibility”\(^{671}\). That is, failure to comply, deliberately or inadvertently has the same result, benefits will cease.

Corporations receiving welfare are generally not subject to any mutual obligation ‘to give something back to the community that supports you.’ An example of a company receiving government benefits without fulfilling its mutual obligation arose in Victoria in 1998. The Victorian government granted Lufthansa a “substantial incentive package”\(^{672}\) including “payroll tax breaks and significant rent discounts”\(^{673}\) so that Lufthansa would establish a call

\(^{667}\) Australian Commonwealth Government, Centrelink

\(^{668}\) Ibid

\(^{669}\) Ibid

\(^{670}\) Ibid, p2

\(^{671}\) Ibid

\(^{672}\) Baragwanath C and Howe J, *Corporate Welfare: Public Accountability for Industry Assistance*, as above, p11

\(^{673}\) Ibid
centre in Victoria employing 300 people. Lufthansa disputed their obligation to employ 300 people claiming that they had agreed to employ only 100 people. In the event Lufthansa only employed 50 people and the Victorian government supported Lufthansa in an action against those employees when those employees attempted “to gain award coverage in the Australian Industrial Relations Commission.”

The Lufthansa example is not an isolated example of corporate welfare recipients not fulfilling their mutual obligation for the receipt of welfare. Rather, the governments providing welfare to corporations do not require any mutual obligation in return for the assistance given to corporations. The former Auditor-General of Victoria, Ches Baragwanath and a Victorian Academic John Howe summarised the position by stating that

“At a time when ‘mutual obligation’ is being imposed on the recipients of social welfare, businesses that receive public assistance are not required to disclose sufficient information to satisfy probity and public accountability requirements.”

**Means Testing**

Corporate welfare is not subject to means testing of the recipient, as is individual welfare.

Not all individual welfare is subject to means testing, for example, access to public education, access to public hospitals and the use of government provided infrastructure such as roads and parks. However, direct government welfare payments such as the Newstart Allowance and Aged pensions, for example, are subject to very strict, inflexible asset and income means testing. In contrast, almost all direct government welfare given to corporations is not subject to any means testing at all.

Commonwealth government payments to individuals that are subject to both asset and income tests are

- ABSTUDY
- Age pension
- Ausstudy payment
- Bereavement allowance
- Carer payment, adult

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674 Ibid
675 Ibid
676 Ibid
677 Ibid, p v
- Carer payment, child
- Disability support pension
- Mature age allowance
- Newstart allowance
- Parenting payment
- Partner allowance
- Sickness allowance
- Special benefit
- Widow allowance
- Widow B pension and
- Youth allowance

A single homeowner will be eligible for the full pension, of $488.90 per fortnight, if they pass both the assets and the income test. The value of all assets, apart from the home must not exceed $157,000 and the income earned must not exceed $124 per fortnight. Assets over $157,000 will reduce the pension by $3 per fortnight for every $1,000 above the limit, and income over the $124 per fortnight reduces the rate of pension payable by 40 cents for each extra dollar earned.

As with the mutual obligation imposed on individuals receiving Commonwealth welfare, the income and assets tests are proscribed in great detail. The penalties for failing to comply with either the mutual obligation or income and assets tests are generally repayment of any overpayments and, in the case of the Newstart Allowance a loss of the allowance for an extended period of time.

Corporate welfare is not made contingent to means testing of any sort. Some forms of corporate welfare, for example, tax concessions for research and development only benefit profitable corporations. Other forms of corporate welfare, such as tariffs protect the profitable and unprofitable, the large and the small corporations in a particular industry. This is to be expected because these blunt instruments of assistance act indiscriminately. However, sharper forms of assistance such as direct grants of cash or kind are, unlike

678 Australian Government, Centrelink
679 Australian Government, A guide to Australian Government payments, booklet 1 January – 19 March 2006, p7
680 Australian Government, Centrelink
681 Australian Commonwealth Government, Centrelink
personal welfare, also handed out irrespective of the wealth and earnings of the corporation receiving the benefit.

The then Prime Minister, John Howard, in his Federation Address presented in 1999 announced that the government would provide financial assistance of $40 million to the Visy Pulp and Paper Mill in Tumut in NSW. The reason the Prime Minister gave for this assistance was that “the Australian way has also always involved great projects of national development.” When the Minister for Forestry and Conservation, the Honourable Wilson Tuckey, announced the $40 million assistance to Visy, he said the “Government’s support for the Visy project is a strategic decision to position Australia as an important source of value added forest products in the region”, further the project will have “positive trade and regional employment impacts”.

Visy is a private company owned by the Pratt family and, according to the Visy homepage, “it has grown to become one of the world’s largest privately owned packaging and recycling companies.” The company also announced that in 2005 its “total manufacturing revenues exceed $2.8 billion and total manufacturing assets exceed $3 billion.” The chairman and major shareholder of Visy, Richard Pratt, is estimated to have personal wealth of at least $4.7 billion.

The paper mill in Tumut was completed by Visy in 2001 at a total cost of $450 million, which included the $40 million gift from the Australian government. The Tumut plant employs 150 people on the site. If employment creation were the only aim of the assistance then, dividing the $40 million by the number of jobs on the site, could be seen to be a subsidy of $266,000 per job.

The fact remains that Visy is a private for profit company that would not have made an investment without doing a cost benefit analysis. The Australian government has given this company a substantial amount of money but has no say over how the money was spent, no guarantees as to the number of jobs that will be created and no guarantees as to the trade

683 Ibid
686 Ibid
687 Stevens M, ‘Box baron will probably fold’, *The Australian*, 23 December, 2005, finance news
impacts of the plant’s production. The government has no right to ask for any of the money to be repaid if and when the plant reaches a certain level of profitability.

A twist to the Visy tale occurred in November 2007 when Visy was ordered to pay $36 million, the largest fine in Australian corporate history, for price-fixing. The fine did not even manage to recoup the government gift of $40 million.

Baragwanath and Howe support the suggestion that “recipients of industry assistance could be subject to a repayment program (sic) along the lines of the Higher Education Contribution Scheme, which requires tertiary students to repay tuition fees once they reach a certain income level.”

**Transparency**

Corporate welfare is not provided in as transparent a manner as is individual welfare. The reason given is the need for commercial in confidence.

Transparency in this context of providing welfare means transparency as to:

1. How much welfare is being provided and,
2. The eligibility conditions of the welfare provided

Any person can access the Australian Government publication *A guide to Australian Government payments*, a booklet produced quarterly, that details all the welfare entitlements of recipients of individual welfare. Anyone can see how much welfare a person is receiving when that person is on any type of Australian Government benefit. Anyone can also see exactly what the eligibility requirements are in respect of any individual welfare payment, including what asset and income tests the person has to meet to receive that payment.

As an example, to be eligible to receive a disability support pension you must be

- Aged 16 or over but under Age Pension age at date of claim lodgement; AND

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692 Ibid, p8
- Must have a physical, intellectual, or psychiatric impairment assessed at 20 points or more; AND
- Inability to work for at least the next two years as a result of impairment; AND
- Inability, as a result of impairment, to undertake educational or vocational training which would equip the person for work within the next two years OR
- Aged 16 or over, but under Age Pension age at date of claim lodgement; AND
- Be permanently blind

In addition to this information the booklet also details residential requirements, basic rates of the payments, rent assistance, and the income and the assets test you must pass to receive the payment\textsuperscript{693}.

As well as the publicly available information above, the government has even, recently, conducted a television advertising campaign to make the general public aware of some of the conditions for receiving individual welfare. The general public is encouraged to let the government know of any individuals receiving welfare that are not complying with the welfare rules.

Not only are the lives of individual welfare recipients stripped bare before the Australian government or agency making the payment, their lives are stripped bare and denied the dignity of privacy before the entire Australian public.

Contrast this treatment of individual welfare recipients with corporate welfare recipients where neither the amount of welfare provided nor the eligibility conditions of the welfare provided are made public. Baragwanath and Howe found that for State government assistance, for example, “industry assistance is normally dispensed in accordance with internal administrative guidelines and agreements between governments and the recipients of assistance. Legislation does not normally govern the delivery of assistance, with authority for particular assistance arrangements a matter of Ministerial discretion”\textsuperscript{694}. This Ministerial discretion is not governed by legislation to “set parameters or guidelines for the exercise of the discretion”\textsuperscript{695}. This wide ministerial discretion puts ministers in the invidious position of making decisions that could lay them open to charges of political corruption by disgruntled businesses that may not have received assistance while others are receiving assistance.

\textsuperscript{693} Ibid, pp8 and 9
\textsuperscript{694} Baragwanath C and Howe J, \textit{Corporate Welfare: Public Accountability for Industry Assistance}, as above, p17
\textsuperscript{695} Ibid
The eligibility conditions of industry assistance are not transparent nor are the amount of assistance given to firms transparent. Even though State government departments produce publicly available annual reports and “while these reports often list the recipients of assistance, they do not disclose the actual amounts provided to particular corporations.” Generally, “only the amount of financial assistance provided in toto to private companies during the year is reported.” However, as the following example will demonstrate, even the amount of financial assistance can be in dispute.

In 1995 the NSW government agreed to an assistance package with Fox Studios to encourage the company to establish a film studio on, formerly public space, near the city. The NSW government maintained that the amount of government assistance provided to Fox Studios was around $25 million. The NSW Auditor-General, however, estimated that the assistance was valued at between $84.8 million and $106.8 million, excluding the value of the lease of 24.3 hectares of public land. The government is in dispute with its own auditor as to the value of the subsidy with the auditor believing that the government has only recognised a fraction, 23% to 39%, of the value of the assistance given. This puts into doubt the accuracy of the limited information available to the public, via the release of the State annual reports.

Freedom of information legislation, Commonwealth and State, is normally the authority for access to government information is of no help in getting information about corporate welfare. This is because the “effectiveness of these laws is limited by the often wide scope of the exemptions granted … and … in some cases, information relating to the provision of industry attraction incentives is specifically exempted.”

There is little transparency about government handouts to business. Baragwanath and Howe stated that

The lack public access to government information, however, means that it is extremely difficult to determine the extent to which State Governments subject industry assistance to performance criteria by which the public interest can be

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696 Ibid, p19
697 Ibid
698 Ibid, p12
699 Ibid, p19
assessed. Even more difficult is the task of assessing the internal monitoring procedures, if any, adopted by governments\textsuperscript{700}.

Corporations receiving government welfare don’t face the same scrutiny of their affairs when applying for and receiving welfare. The privacy of individuals receiving welfare attracts no such concerns, as can be seen from the above.

**Corporate Welfare not quantified**

Much corporate welfare is not quantified. The reason given for this is the “extreme difficulty, if not impossibility of quantifying”\textsuperscript{701} some forms of corporate welfare, for example, trade controls, credit restrictions etc. The failure to acknowledge the importance and the cost of corporate welfare that is difficult to quantify is also “an illustration of an all too familiar weakness of contemporary economics – the tendency to assume that only those variables which can be quantified are of real importance.”\textsuperscript{702} However, the difficulty in quantifying some forms of corporate welfare does not explain the fact that our Commonwealth government attempts to quantify industry assistance in its Annual Productivity Commission Report and the reluctance of State governments to report on the amounts they spend on corporate welfare. This failure to quantify is not as apparent in the provision of individual welfare. As we have seen above, even when the State governments report on the amount of corporate assistance they have provided the amount information is limited and the quantum reported may be vastly understated.

Every year the Australian government, and the Australian people, receives a report from the Productivity Commission that “is required to report annually on industry assistance and its effects on the economy.”\textsuperscript{703} The Productivity Commission reports in terms of ‘data’ and ‘estimates’. The Commission uses data to report on budgetary assistance, that is, direct cash assistance and taxation relief that can be quantified. The Commission does not shy away from attempting to estimate assistance that is not so easily quantifiable. These assistance measures include tariff assistance, agricultural regulatory and pricing assistance and anti-dumping measures\textsuperscript{704}.

\textsuperscript{700} Baragwanath C and Howe J, *Corporate Welfare: Public Accountability for Industry Assistance*, as above, p7
\textsuperscript{702} Ibid
\textsuperscript{704} Ibid, p2.1
The State governments, on the other hand, who supply more budgetary assistance to industry than the Commonwealth does, do not report comprehensively on the industry assistance they give. This is despite the fact that budgetary information would be more easily able to be calculated than non-budgetary assistance, which needs to be estimated.

**Competition to Hand out Welfare**

Competition to hand out corporate welfare is when Australian States compete against each other and the Commonwealth competes against other countries to see who can afford the most generous handouts.

When Australia as a nation competes against other nations to hand out corporate welfare it does so in the hope that a company will establish itself in Australia. Footloose capital attracted by such welfare can, by its very nature, always choose “to exercise its exit option whenever a government puts burdensome constraints on the conditions for domestic investment in the attempt to protect social standards, maintain job security, or preserve its own ability to manage demand.”\(^705\) In this way nation states become the hostages of the capital it has attracted. Governments are then put in the situation of attacking their own living standards in order to keep the corporation it has attracted. The Victorian government supporting Lufthansa against the wage demands of its Australian employees is one such example. Corporate welfare also breaks the WTO and GATT agreements “which demand free trade, free of subsidies.”\(^706\)

Baragwanath and Howe conclude that

In the current environment, it is clear that nobody wants to rock the industry assistance boat. Industry is content with a process that allows it to ratchet up offers of assistance from competing States. States, particularly those of the rust belt variety or those States with Governments facing impending elections, appear satisfied with a system that allows them to bid up taxpayers’ funds with impunity, confident that such largesse will remain concealed by a veil of commercial in confidence. In this context, it is not surprising that the Industry Commission recommendations aimed at improving the system have fallen on deaf ears.\(^707\)


\(^{706}\) Tooth G, producer, *Welfare for Business*, on ABC Radio National, as above, p2

\(^{707}\) Baragwanath C and Howe J, *Corporate Welfare: Public Accountability for Industry Assistance*, as above, p8
The Rationale for Corporate Welfare

All levels of government in Australia, whatever their politics, provide corporate welfare. The reasons for governments supporting private corporations with public monies must be the belief that it provides a public good. In general, “it is maintained that new investment will generate economic growth that in turn will create employment and improve standards of living.”\textsuperscript{708} In other words, economic growth is seen as a good because it is seen to create employment and raise standards of living, that is, economic growth is not a good unless these benefits follow.

Unfortunately, the Commonwealth Governments’ own Productivity Commission has assessed most State based corporate welfare programmes as not adding to the good of either creating employment or improving standards of living.

If corporate welfare does not advance employment or living standards the question of why all levels of government provide corporate welfare remains. I believe there are three main reasons for providing corporate welfare.

1. Political
2. Corporate lobbying and
3. Political donations

1. Political
Governments must be seen to be doing the best for their constituents. One clear way of demonstrating this commitment is to ensure that the government of the day is seen to be supporting local employment and local industry. This is the so-called prisoners’ dilemma of governments competing to hand out corporate welfare. I see it as a political dilemma and confusion between competitive federalism (good) and competition to attract a firm to a particular region of jurisdiction (bad). Competitive federalism “ensures that Governments are under constant pressure to provide quality goods and services at the lowest possible costs.”\textsuperscript{709} This federalism should provide people and businesses with the best climate for all activity, business and personal.

That corporate welfare is good politics can be seen by the comments like “Australia’s state governments are eagerly handing over millions of taxpayers’ dollars as they bid for jobs and

\textsuperscript{708} Ibid, p1
\textsuperscript{709} Industry Commission, \textit{State, Territory and Local Government Assistance to Industry}, as above, p26
votes.\textsuperscript{710} In other words, efforts at obtaining jobs is seen by politicians as votes. The private views of the politicians are more realistic about the usefulness of corporate welfare bidding wars. For example, “one former premier calls the bidding wars a ‘pissing contest’, and says ‘I was always happy when we lost’”\textsuperscript{711}.

2. Corporate Lobbying

“In Australia, corporate pressure on governments to continue industry assistance is intense. Formidable corporate lobby groups exert pressure on governments at every step of the policy-making process to maintain or further increase government assistance.”\textsuperscript{712} A recent example of this intense lobbying was the campaign by the government, trade unions and employer groups with respect to the industrial relations reform passed in the Australian parliaments, representatives and senate.

3. Political Donations

Corporations make donations to political parties. In Australia, political donations of “amounts over $1,500 must be declared to the Electoral Office.”\textsuperscript{713} The Australian electoral Commission reports annually on donations made to political parties and reveals “tens and sometimes hundreds of thousands of dollars are paid by companies to their preferred political party.” Public disclosure of political donations is a good because it can allay issues of probity with respect to connections between political donations and government welfare. However, “what is not listed are trusts used to channel these funds (political donations) without disclosure of the donor’s identity.”\textsuperscript{714} Even though in Australia, there is some transparency about political donations, they can still be seen to be an investment by corporations and still raise probity issues. “Ten thousand dollars or even a million dollar donation may make politicians’ mouth water, but they are peanuts to corporations, and excellent investments even if they only sway legislators occasionally.”\textsuperscript{715}

The existing disclosure requirements are however, under threat. “The government has indicated it will amend the Commonwealth Electoral Act to require disclosure only by those companies giving more than $10,000 to political parties. … The government also plans to

\textsuperscript{711} Ibid
\textsuperscript{712} Van Dyke L, ‘Milking the System: How corporate welfare fleeces the taxpayer, destroys the environment and corrupts public policy’, Published in Overland, 2003, pp110-116, p114
\textsuperscript{713} Ibid
\textsuperscript{714} Ibid
increase tax deductions for political donations for individuals from $100 to $1,500 a year.”  

The party of government, the Liberal Party, has sent pamphlets to 1,000 company directors asking for donations to keep the Liberal Party in government, which will, in part, “boost corporate profits”.

There are many examples in Australia of donors to political parties receiving direct government welfare. “Two recent examples involve Visy Pty Ltd and Manildra Pty Ltd, whose CEO’s are both friends of the Prime Minister John Howard, which have both made generous political donations. Visy received $40 million to start up a Tumut Pulp Mill and the Manildra Company was handed a virtual monopoly by the Coalition government for its ethanol fuel mix, by slapping a 38c excise on imported ethanol.”

The Prisoners’ Dilemma of State Corporate Welfare

The prisoners’ dilemma is a device used to explain the social contract morality of rational self-interest. The prisoners’ dilemma occurs when two prisoners are interrogated separately about a crime. “If one confesses and the other doesn’t the confessor gets a light sentence and the non-confessor a very heavy one. If both confess, each gets a sentence of intermediate length, if both keep quiet they each get a sentence only slightly longer than that of the single confessor.”

It is in the best interests of both prisoners to say nothing. However, since neither can be sure of what the other will do, both confess, and both end up worse off. The rational course would be for the prisoners to co-operate and receive the benefits of co-operation.

States compete with each other in the provision of corporate welfare. The Industry Commission found that

much of the considerable selective assistance provided to industry by State and local governments has little or no positive effect on the economic welfare of Australians as a whole. Most selective assistance is part of harmful State and local government.

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717 Ibid
718 Van Dyke L, ‘Milking the System’, as above, p114
rivalry for economic development and jobs, which at best shuffles jobs between regions and at worst reduces overall activity. 720

The Industry Commission conducted quantitative modelling that supported the conclusions that “when one State provides assistance in isolation:

- There are clear short-term benefits only if the cost of financing the assistance can be ignored or avoided;
- The long-term benefits are dubious and any gains are likely to be small; and
- Costs are imposed on the other States and on the economy as a whole.” 721

This situation only gets worse when all States provide assistance. In that case the modelling supported the conclusion that when all States provide assistance then “there are likely to be losses all round.” 722

All of the benefits put forward by government for providing selective corporate welfare assistance were found by the Productivity Commission to be either illusory or vastly overstated. The various benefits are

- Alleviating the effects of market failure
- Multipliers
- Agglomeration
- Demonstration or ‘lighthouse’ effect
- Regional development
- Intangibles

Alleviating the effects of market failure

The Productivity Commission grudgingly accepted that there would be occasions when market failure will warrant government intervention. “Classic examples are, public goods (such as defence), or where the market fails to signal sufficiently the benefits (R&D), or costs (pollution), and where information problems and transaction costs are particularly high (standards for weights and measures etc).” 723 The Commission recommends that, “some of these difficult challenges can be overcome by legislation which specifies property rights

721 Ibid, pp xxx and xxxi
722 Ibid, p xxxi
723 Ibid, p29
clearly rather than by direct assistance.” 724 I would also question the prudence of having public goods being provided by private corporations motivated by profits and subject to the vagaries of uncertain market forces.

The Commission concluded that, “in reality, governments often lack the information and expertise necessary to identify and then correct market failure in a manner which ensures that the positive effects outweigh the negative, including the costs of financing the intervention.” 725

Multipliers

Multipliers are measures of economic linkages that are said to generate employment and economic activity “elsewhere in the economy, additional to the investment associated with the project itself.” 726 The positive multiplier effect “usually turns out to be myth” 727. The Productivity Commission holds that a positive multiplier effect can be claimed only when you can “measure a net gain to the economy only to the extent that their demand on resources for associated activities can be met from resources which otherwise would not be used. … If an expansion of one industry can occur only by bidding resources away from another industry, then there is no net multiplier effect.” 728

Agglomeration

Agglomeration is the “tendency for firms in the same and closely related industries to locate within close proximity of each other” 729. Agglomeration is seen as beneficial because, as the South Australian government put it to the Productivity Commission,

“Investment attraction can bring with it less tangible but significant benefits such as the introduction of new skills, new technologies, new management practices, and connections into other countries or into multinational enterprises.” 730

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724 Ibid
725 Ibid
726 Ibid, pp30-31
727 Ibid, p31
728 Ibid
729 Ibid, p32
730 Ibid
Some of the gains of agglomeration have been identified as the raising of the skill levels of labour, clustering of suppliers and users lowers the costs of inputs, lower transportation costs and higher demand for specialised components encourages their production\textsuperscript{731}.

The Productivity Commission concluded that although “the gains from agglomeration are real for firms involved … the reasons why some clusters are successful and others are not, and the reasons for their initial location in a particular area, are little understood. Thus it is difficult for governments to be able to make sound judgements as to the appropriate amount of assistance that should be provided, or to know if any success was the result of their efforts or would have occurred naturally.”\textsuperscript{732}

A major problem of agglomeration is the growth of towns or regions that rely on one industry for employment. This lack of diversification makes the town or region vulnerable to the vagaries of the fate of the industry in question. For example, the South Australian government has a long history of supporting the automotive industry and has, in a real sense become a hostage to the viability of the motor industry. In South Australia car manufacturers have a long record of being able to successfully extort welfare from the government with the threat of closure or downsizing. The recent experience of Mitsubishi Motors Australia provides a good example of this vulnerability. In April 2002 the Prime Minister Mr Howard announced $35 million of assistance to Mitsubishi from the Commonwealth government in addition to $200 million of assistance from the Automotive Competitiveness and Investment Scheme and in addition to $50 million provided by the South Australian government\textsuperscript{733}, that is, a massive $285 million worth of corporate welfare to Mitsubishi motors. In return Mitsubishi create “an additional 900 direct jobs in Mitsubishi’s Adelaide manufacturing operations and the establishment of a global research and development centre in South Australia with ongoing employment of approximately 300 people.”\textsuperscript{734}

A mere two years after Mitsubishi was given $285 million to create new jobs the Federal government announced another $50 million assistance to help Mitsubishi to reduce its workforce\textsuperscript{735}. In 2005 Mitsubishi cut about 1,000 jobs in voluntary redundancies in Adelaide and plans to cut another 250 jobs in Adelaide during 2006.\textsuperscript{736} At the same time that these job

\textsuperscript{731} Ibid
\textsuperscript{732} Ibid, pp33-34
\textsuperscript{734} Ibid
\textsuperscript{736} Bockmann M W, ‘Car plant forced to shed jobs”, The Australian, 21 January, 2006,
losses were reported it was also reported “GM Holden also retrenched 1,400 workers from its Adelaide assembly plant.”\textsuperscript{737}

Demonstration or ‘lighthouse’ effect

The demonstration or ‘lighthouse’ effect is when a high profile firm is attracted to a country, state or region to advertise or show the attractiveness of the location in the hope that other investment will be attracted to the location\textsuperscript{738}. The Productivity Commission found that “once governments become involved in providing selective assistance there seems to be no apparent policy of ceasing such a policy even after a series of ‘lighthouses’ has been assisted often over many decades. Moreover, there may be more efficient means of dealing with perceived information problems, and ‘lighthouse’ assistance may be less effective in fostering investment than more general measures to create an efficient business environment.”\textsuperscript{739}

Regional development

“Regional development, particularly the development of depressed regions plays an important role in the economic development policies of government. In the EU, where the Treaty of Rome specifically seeks to limit industry assistance by member states, assistance to the depressed regions is one of the exceptions to that policy.”\textsuperscript{740} The South Australian Government, in its submission to the Productivity Commission enquiry in 1995 said “levels of industry attraction are a policy issue for State Governments in response to the needs of their electorates.”\textsuperscript{741}

If this response by State Governments is based on voters making informed choices about the costs and benefits of regional assistance then voters “have the right through the democratic process to give expression to such preferences.”\textsuperscript{742} If the cost of the regional assistance is, however, being paid for by people in other regions or jurisdictions, then the assistance is being unfairly subsidised. The greater problem with regional development aid is however that it perpetuates inefficient productivity and diverts resources away from efficient productivity. The Productivity Commission put it this way, “In general the decline of some

\textsuperscript{737} Ibid
\textsuperscript{738} Industry Commission, \textit{State, Territory and Local Government Assistance to Industry Report}, as above, p 35
\textsuperscript{739} Ibid, p36
\textsuperscript{740} Ibid
\textsuperscript{741} Ibid, p37
\textsuperscript{742} Ibid
regions and the expansion of others reflect changes in the relative productivity of regions. In
the longer term, such changes bring an improvement in the use of the community’s scarce
resources.”743

Intangibles

Intangible benefits are those like ‘feel good’ effects of the population in the region involved.
“Surveys confirm that the citizens of a State are often in favour of their government bidding
for a specific firm or event (particularly when it is successful) as it leads to the citizens
themselves feeling that they live in a successful State capable of attracting major events or
firms. In these cases, the costs to the citizen can seem small and the gains considerable.”744
Unfortunately, the productivity Commission “observed that rarely is sufficient information
provided publicly for such a judgment to be formed.”745

In November 2002, the Productivity Commission chairman, Mr Banks, stated that, “as the
Sydney Olympics highlighted, there may also be a ‘feel good’ factor associated with
attracting major investment, which should not be dismissed just because it is hard to
measure.”746 He went on to add that, “as the Grand Prix saga illustrated, in some cases there
may be a ‘feel bad’ factor to consider for the losing State!”747

Banks stated “from a national perspective, inter-State competition for investment conducted
via selective assistance is a negative-sum game.”748 The Productivity Commission found that
despite knowledge by the States of the negative effects of bidding wars between States, the
States “find it difficult to withdraw from what they see as a prisoners’ dilemma because of
the perceived costs of withdrawal, both economic and political. There is also recognition that
any substantial reform will require concerted collective action by the States.”749

“The annual report from Victoria’s Department of State and Regional Development provides
many examples of money wasted. Opposition industry spokeswoman Louise Asher found
five firms receiving more than $100,000 in handouts from the Bracks Government –

743 Ibid
744 Ibid, p38
745 Ibid
746 Banks G, ‘Inter-State bidding wars: calling a truce’, Speech to the Committee for Economic
Development of Australia, Brisbane, 6 November 2002, p11
747 Ibid
748 Ibid, p12
749 Industry Commission, State, Territory and Local Government Assistance to Industry Report, as
above, p xxxiii
Austrim, Arnott’s Email, Nestle and Rocklea Spinning Mills – had either closed their Victorian operations or shed jobs.”  

Conclusion

“There is universal agreement that governments have a vital role to play in setting the scene for economic development.”

Governments can set the scene for economic development by providing

- “Efficient user-friendly infrastructure such as education, roads, ports and waste management and operating these in an efficient low-cost way;
- Simple, stable and transparent institutional rules which facilitate interactions and lower transaction costs of doing business, by establishing user-friendly laws and regulations, and enforcing them convincingly: and
- Macroeconomic stability, particularly a non-inflationary economic climate.”

This list of items of appropriate government spending which assists industry also makes for a stable society for the humans living in it. To this list I would add items such as health care, utilities, political stability, clean air and water, safety.

Corporate welfare in the form of specific firm or specific project assistance provides, as was demonstrated above, debatable economic benefits. In the course of preparing its State, Territory and Local Government Assistance to Industry Report the Productivity Commission received submissions from a number of participants arguing, “that industry assistance is not an appropriate tool for State economic development policy.” These submissions were not from welfare groups but from State Chambers of Commerce who represent industry.

The Tasmanian Chamber of Commerce and Industry said:

By and large competition between the States for business investment improves economic efficiency in Australia. Whether it be energy prices or tax structures, industry regulation or the cost of workers’ compensation, ‘competitive federalism’

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Productivity Commission, State, Territory and Local Government Assistance to Industry Report, as above, p25
Ibid
Ibid
Ibid
ensures that governments are under constant pressure to provide quality goods and services at the lowest possible costs.

There is, however, a sharp distinction between beneficial competition over the general business climate and competition that discriminates in favour of a particular industry or business. When governments compete over financial and other incentives to attract business (particularly tax holidays) then the competition becomes destructive and inefficient.\(^{754}\)

This sentiment was echoed by the WA Chamber of Commerce and Industry who said:

> It is far more important for government to get its overall economic policy management and fiscal strategies right.

> The best assistance which the government can give to industry is to create a favourable climate for all business activity\(^ {755}\).

All corporate welfare provided by way of cash handouts is selective and “benefits one firm or group of firms at the expense of others, puts taxpayers’ funds at risk and encourages a business handout mentality.”\(^ {756}\)

There is a dichotomy between the beliefs in the operation of free markets, unimpeded by government interference and selective corporate welfare. Neoliberals could not hold the view that corporate welfare was anything but an interference in, and distorting influence on, free trade.

In November 2002, the Productivity Commission chairman, Mr Banks, at an address to the Committee for Economic Development on the issue of corporate welfare “said that in most cases the state governments were fighting over projects that were destined for Australia even without state government incentives and, consequently, the federal Government should handle all such negotiations.”\(^{757}\) He concluded that the present bidding between states lead to “overbidding for projects and events relative to the national benefits to be obtained … and that … interstate bidding can cause national benefits to be dissipated, with foreign

\(^{754}\) Ibid, p26  
\(^{755}\) Ibid In November 2002, the Productivity Commission chairman, Mr Banks,  
\(^{757}\) Fraser A, ‘$3.3bn lost on luring companies’, \textit{The Australian}, 7 November, 2002, p5
shareholders the only sure winners.” Mr Banks suggested that all public assistance to companies “be made public so that taxpayers could judge if the assistance was worthwhile … and … he called for explicit selection criteria, rigorous assessments, public announcements of the nature and value of assistance, and monitoring by independent agencies such as audit offices.”

These suggestions by Mr Banks to improve the efficiency, accountability, and propriety of corporate welfare seem sensible and appropriate. However, “Mr Banks” speech was badly received by his Brisbane audience, many of whom were from the public sector: one questioner said the address was ‘specious, idle, foolish and misleading’. 

Factors Influencing Investment Location Decisions

Dr Alan Preston, while Deputy Secretary (Fiscal) to the Australian Treasury, in 1994 summarised the results of three large-scale international studies, which ranked the significant factors influencing locational choice. These studies were attempting to assess the importance of tax factors on location decisions of international businesses. The three studies were commissioned by, the Commission of the European Communities, the Business International Advisory Committee looking at Asian investment and the Export-Import Bank of Japan.

In order of importance, the studies show that the most significant factors influencing locational choice are,

- “the quest to take up a stake in regional markets so as to preserve and/or expand global market share;
- access to raw materials;
- access to a low cost skilled workforce;
- a well-developed local infrastructure;
- an efficient and honest public sector; and
- political stability.”

Preston concluded that, “the importance of these non-tax factors is perhaps not surprising. In Australia, company taxes represent about 3 to 8 per cent of a business’s costs, very much

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758 Ibid
759 Ibid
760 Ibid
762 Ibid
less than the cost of inputs such as labour (25 per cent) and materials (45 per cent).”763 This was written in 1994 when Australia’s company tax rate was 33%.764 In 2005 the company tax rate has fallen to 30%. If company taxes represent 3% to 8% of costs and if corporate welfare is roughly one-third of company tax paid then corporate welfare would be an even less significant factor in influencing a company’s location.

A report commissioned in 2000 by the Department of State and Regional Development and completed by PriceWaterhouseCoopers found that the significant factors influencing locational choice were,

- access to markets;
- perception of ‘business climate’;
- market stability and likelihood of growth;
- access to suppliers;
- fiscal regime (taxes and duties);
- cost base;
- track record; and labour issues765

The study found that “the availability of grants and other financial incentives become important if there are more than 2 possible locations that have equivalent advantages with respect to the main considerations.”766 The availability of grants and other incentives are not a decisive consideration for companies making locational decisions; they are marginal and only come into play when other factors are equivalent. This would be a rare situation.

Preston, discussing the impact of global tax competition to attract business investment concludes, “Such tax competition is likely to result in some misallocation of the world’s capital and reduced global output.”767 The same conclusion can be drawn with respect to the competition between Australian States and between Australia and other countries to provide corporate welfare as a locational incentive.

Preston concludes that as a result of tax competition “individual nations may hope to increase their share of the world’s lower income, if they calculate that other countries will

763 Ibid
764 Ibid, p28
766 Ibid
767 Preston A, ‘Taxation policy and Australia’s competitiveness’, as above, p24
not either match or otherwise neutralise their tax incentives.”\textsuperscript{768} The Auditor General of Victoria comes to the same conclusion about competition to provide corporate welfare. He states, “There is little argument that local economies can gain from encouraging direct investment. … Nevertheless, the provision of investment incentives can be viewed also as encouraging non-productive rent-seeking behaviour. If incentives to footloose companies actually have no impact on locational decisions, then these represent a transfer of resources from the government to specific companies, some of which pays for the cost of lobbying the government for funds. The real cost is the loss of government funds for spending on other services.”\textsuperscript{769}

\textsuperscript{768} Ibid
\textsuperscript{769} Auditor General Victoria, \textit{Investment attraction and facilitation in Victoria}, as above, p28
Chapter 6 Corporate Tax Avoidance

Introduction

All taxpayers, individuals and corporations can engage in tax avoidance activity. This chapter will concentrate on corporate tax avoidance because of the legal form of a corporation allows corporations to engage in the single largest tax avoidance activity – transfer pricing. This chapter deals with all forms of tax minimisation, the legal forms commonly called avoidance or planning, and the illegal form, commonly called evasion, in the same way and calls them all tax avoidance. The boundaries between all these forms of tax minimisation have become blurred and are all referred to as tax avoidance. The term tax avoidance is used because using legal loopholes to avoid taxation responsibilities is as morally reprehensible as using illegal forms of avoiding taxation obligations. Ray Kendall, a former Secretary General of Interpol, in his review of a book that discusses the impact of ‘dirty-money’ on capitalism stated, “Our ability to be notionally legally but ethically and morally bankrupt is destroying capitalism.”770 If a person who has committed a criminal offence is found not guilty on a legal technicality it does not alter the fact that the person actually committed the offence. If a corporation avoids paying taxation on a legal technicality it does not alter the fact that the corporation has avoided tax.

The single most effective tool that corporations use to minimise their tax liabilities is transfer pricing. Transfer pricing is uniquely available to corporations and is the most common tax planning tool used by corporations.

Tax avoidance by corporations is particularly important firstly, because of the enormously disproportionate impact corporations have, as compared with individuals on the economy of a country. It has been estimated that “the world’s largest 100 corporations control 20 per cent of global foreign (to the United States) assets and around 60 per cent of world trade is internal to multinational corporations”771. Secondly, corporations are a unique form of business organisation that offers many more opportunities to engage in tax avoidance than are available to individuals.

770 Baker RW, Capitalism’s Achilles Heel: Dirty money and how to renew the free-market system, published by John Wiley & Sons, Inc., United States of America, 2005, p1
771 Woodiwiss M, Gangster capitalism: the United States and the global rise of organised crime, published by Constable and Robinson Ltd, United Kingdom, 2005, p187
Tax Avoidance and Tax Evasion

Tax avoidance is “a scheme or arrangement where a taxpayer enters into a transaction that complies with the letter of the tax law but has the effect of obtaining a tax benefit. The tax benefit of a tax avoidance scheme may be nullified under the anti-avoidance provisions in the Income Tax Assessment Act (Cth) 1997 (‘ITAA’) Pt IVA. Traditionally tax avoidance was distinguished from tax evasion because avoidance does not involve active or passive fault by the taxpayer.” Tax evasion is the “illegal non-payment of tax that would be properly payable if a full and true disclosure of assessable income and allowable deductions had been made. Tax evasion involves a breach of legal obligations. Tax evasion involves breaches of the law or skilful exploitation of loopholes in the law for the specific purpose of evading taxes.” Even the legal dictionary blurs the meanings of tax avoidance and tax evasion by stating that tax evasion can mean the ‘skilful exploitation of loopholes’, which is not illegal and could therefore be considered merely tax avoidance.

Fullagar J, in Australasian Jam Co Pty Ltd v FCT held that the “word ‘avoidance’ unlike the word ‘evasion’ does not, on my opinion, involve a notion of active or passive fault on the part of the taxpayer. If the absence of full disclosure has in fact resulted in less tax being paid than ought to have been paid, there has been an avoidance of tax”. The distinction between tax avoidance and tax evasion, where avoidance implies ‘no fault’ and evasion implies ‘fault’ on the part of the taxpayer was been maintained in this decision.

It is sometimes difficult to distinguish between tax avoidance and tax evasion. A financial consultant, Jo Cleary, expressed the blurring of meanings by stating, “the use of the term ‘tax avoidance’, which was used to describe something acceptable and legal, … came to be used … to describe something unacceptable and illegal.” Cleary was describing changing attitudes to tax avoidance from the 1970’s, when the tax avoidance industry boomed in Australia, to the end of the 1980’s when the tax avoidance industry was no longer considered respectable. This changed in 1991 when Australia’s then richest man, Kerry Packer, told a senate inquiry that “If anybody in this country doesn’t minimise their tax they want their heads read because, as a government, I can tell you you’re not spending it that well that we should be donating extra.”

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772 Nygh PE and Butt P (Eds), Butterworths Australian Legal Dictionary, published by Butterworths, Australia, 1997, p1149
773 Ibid
774 [1953] HCA 52
775 Ibid, para 17
777 Castles S, ‘Why the poor are paying the price of the rich’, Canberra Times, 12 January, 2006, p15
Packer’s statement reverberated around the country and helped the tax avoidance industry by again making tax avoidance respectable and morally acceptable. After Packer made his statement few commentators took issue with his “commitment to, and encouragement of, tax avoidance.” In his statement Packer however, misrepresented what tax actually is. Tax is not a voluntary ‘donation’ to be spent as the donor decides, tax “is a form of compulsory contribution from the private to the public sector in order to support intended government expenditure.” Australia is a democratic country and as a consequence, the electorate should determine government expenditure priorities.

Tax avoidance has become such a success “former IMF tax policy chief Vito Tanzi believes that ‘fiscal termites’ – the growing number of ways the rich evade tax – are hollowing out the state and are an economic threat in the new century.” The rich, through their corporations can afford to pay to avoid paying their share of tax. An outstanding example is Kerry Packer who

With an army of lawyers and accountants uncovering every loophole imaginable, Packer’s company paid about 10 per cent tax. Sometimes less. In 1992, on more than $600 million profits worldwide, Consolidated Press Holdings paid $6 million tax.

In other words, in 1992, Kerry Packer’s group of companies paid one per cent tax on their profits at a time when the company tax rate was 34 per cent.

The actions of Packer corporations in minimising their tax can be seen as morally reprehensible only if there is a duty to pay taxes at a specified rate. Under market capitalism the duty of a corporation could, rightly, be seen to be a duty to maximise the return to shareholders. Only if taxation is regarded as a human rights issue will there be a duty imposed on taxpayers, owed to the State as a surrogate for its citizens, to pay taxes at a specified rate. Altruism is not part of the fabric of market capitalism. However, regarding the proper payment of taxes as a human rights issue means that corporations that avoid paying their proper rate of taxation are breaching the human rights of the people in the jurisdiction that taxes are avoided.

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778 Ibid
780 Castles S, ‘Why the poor are paying the price of the rich’, Canberra Times, 12 January, 2006, p15
The Australian government recently announced that it would spend an extra $305 million in order to combat tax evasion through fraudulent offshore tax haven schemes. Although this appears to be a large amount of money, it is to be spread over five separate agencies. The Commonwealth Director of Public Prosecutions (DPP), will for example, receive $60 million to take on “tough cases”. This $60 million is equivalent to three quarters of the annual budget of the DPP. This funding, though a large amount of money will not deter promoters of tax schemes for very long unless the funding is guaranteed to continue for more than one year. The promoters being targeted by this funding are those who promote “illegal tax avoidance, false and misleading statements made to tax investigators and fraud.”

“Officials say more than 100 international promoters have been uncovered by raids and voluntary confessions”. The transactions being promoted “typically involved overstated invoices to send money overseas and claim false deductions ... and ... falsely creating a dispute about an amount owing to an Australian entity, to reduce the amount overtly returned as income. In both situations the excess amount is allegedly secretly returned to Australia via credit cards, debit cards or false bequests”. These schemes are not very sophisticated as they involve dishonesty and fraud. Sophisticated tax avoidance schemes, practiced by the largest corporations, involve structuring tax effective contracts.

Fiscal challenges to the integrity of the taxation system lead to the acceptance of moral challenges to the tax system. “For example, the (then) Australian Prime Minister announced in 2002 that the amiable, wealthy, non-taxpaying tennis player, Pat Rafter, was Australian of the year. The fact that he didn’t pay tax (or even officially reside) in his own country was probably overlooked as most international tennis stars have a tax haven as a place of residence.” The moral signal received by the Australian population is that “our greatest heroes, our most respected and successful citizens, communicate through their actions the message that avoiding tax is normal and acceptable.”

A Pakistani banker, speaking with Raymond Baker about modern capitalism, said

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781 Garnaut J, ‘Millions spent to get big fish in tax crackdown’, *The Sydney Morning Herald*, 9/02/06, p3
782 Ibid
783 Ibid
784 Ibid
785 Ibid
787 Ibid, p25
We have lost the distinction between what is legal and what is illegal. No one hates people who are getting their money through illegal means. Society is not acting as a restraint.\textsuperscript{789}

The banker could have been speaking about the lack of difference between ‘legal’ tax avoidance and ‘illegal’ tax evasion and the moral ambivalence that our society holds about these actions. In Australia, for example, the Prime Minister did not feel compelled to consider the morality of tax avoidance and tax residency of a man he announced as Australian of the year.

The Cost of Tax Avoidance

In December 2005 it was reported that the Deputy Commissioner of Taxation, Paul Duffus, had estimated that “$5 billion is moved out of Australia each year to tax havens around the world”.\textsuperscript{790} $5 billion lost to Australia represents $250 lost per man, woman and child in Australia each year (using an Australian population figure of 20 million). The $5 billion lost to Australia represents 0.66\%\textsuperscript{791} of Australia’s Gross Domestic Product for 2002-2003. This $5 billion is only the tip of the tax avoidance issue because it does not include tax avoidance by the use of transfer pricing by transnational corporations, the cash economy, income splitting, incorrect reporting of income and expenses, the use of trusts to avoid tax etc.

Research done for the Australian Manufacturing Workers Union estimated that “Australia potentially loses $14.3 billion (using 2002 figures) through cash in hand and evaded tax.”\textsuperscript{792} The journalist reporting this story stated that “$14 billion in lost tax could buy 48 new teaching hospitals, 770 new high schools, 5.6 million operations, an infrastructure project the size of the Snowy Mountains hydro scheme.”\textsuperscript{793} The $14.3 billion evaded excludes the traditional ‘legal’ ways of avoiding tax and is therefore, an understatement of the total amount of tax avoided in Australia.

If $14.3 billion of tax evaded in Australia were added to the $5 billion of tax avoided by the use of tax havens, were the total tax avoided then it amounts to 2.56\% of GDP. Again, this is an understatement of the tax avoided in Australia because it excludes the cost of avoidance measures that do not involve the use of tax havens.

\textsuperscript{789} Ibid
\textsuperscript{790} McClymont K, ‘Tax havens reap $5b a year’, \textit{Sydney Morning Herald}, 5 December 2005, p21
\textsuperscript{792} Moscaritolo M, ‘Black economy gst money leaks they just can’t plug’, \textit{The Advertiser}, Adelaide, 31 March 2005, p21
\textsuperscript{793} Moscaritolo M, “Black economy boom despite GST”, \textit{The Mercury}, Hobart Town, 4 April, 2005, p16
The Australian Tax Office investigation into “the use of offshore tax havens for money laundering and tax evasion”\textsuperscript{794} resulted in a number of people receiving summonses to appear before the “crime commission to answer questions as to their knowledge of or involvement in tax fraud or money laundering using offshore tax schemes and tax havens.”\textsuperscript{795} Seven of the people issued with summonses have been attempting to prevent the “Australian Crime Commission from investigating their affairs.”\textsuperscript{796} Although the identities of six of the seven people involved have not been identified by name, they have been identified as follows;

- A South Australian crime figure\textsuperscript{797},
- A Melbourne celebrity lawyer (the only person named, Michael Brereton)
- “A sole proprietor of a business which provides financial and business advice to wealthy entertainment figures based in Australia, the United Kingdom, Europe and the US”\textsuperscript{798},
- Two Sydney solicitors specialising in the provision of complex commercial advice to high profile clients and companies and
- A high profile person associated with the entertainment industry\textsuperscript{799}.

This profile corresponds with the profile of people engaged in moving dirty money around the world by Baker.

Almost all tax avoidance schemes use artificial entities, companies and trusts.

**General Anti-avoidance provisions - Part IVA**

The Commissioner of Taxation, Michael Carmody, in the Australian Taxation Office (‘ATO’) guide to Part IVA said

Part IVA of the Income Tax Act is the general anti-avoidance rule for income tax. It protects the integrity of our income tax system by ensuring that arrangements that have been contrived to obtain tax benefits will fail.\textsuperscript{800}

\textsuperscript{794} McClymont K, ‘Tax havens reap $5b a year’, *Sydney Morning Herald*, 5 December 2005, p21
\textsuperscript{795} Ibid
\textsuperscript{796} Ibid
\textsuperscript{797} Ibid
\textsuperscript{798} Ibid
\textsuperscript{799} Ibid
\textsuperscript{800} Australian Taxation Office, *Part IVA: the general anti-avoidance rule for income tax*, published by the Commonwealth of Australia, Canberra, December 2005, pi
In the preamble to the tax legislation Part IVA is described as “a general anti-avoidance provision designed as a measure of last resort” to be used only after all other specific anti-avoidance provisions of the ITAA have been considered.

The actual language of the legislation requires the above explanatory guides and statements because the legislation does not state the aim of Part IVA, nor is it clear from reading Part IVA that it is a general anti-avoidance rule.

Part IVA of the ITAA comprises sections 177A to 177H of the ITAA. The language used is unhelpful for the reader in determining the intent or the operation of the Part. The substantive section of Part IVA is s177D that “defines eight factors as, in effect, badges of avoidance. These provide warning lights about the possible application of Part IVA.”

These warning lights consist of any scheme entered into by a taxpayer after 27 May, 1981 which confers a tax benefit to the taxpayer and

Section 177D (b) “having regard to –

i) The manner in which the scheme was entered into or carried out;

ii) The form and substance of the scheme;

iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out;

iv) The result in relation to the operation of this Act that, but for this Part, would be achieved by the scheme;

v) Any change in the financial position of the relevant taxpayer that has resulted, will result, or may reasonably be expected to result, from the scheme;

vi) Any change in the financial position of any person who has, or has had, any connection (whether of a business, family or other nature) with the relevant taxpayer, being a change that has resulted, will result or may reasonably be expected to result from the scheme;

vii) Any other consequence for the relevant taxpayer, or for any person referred to in subparagraph (vi), of the scheme having been entered into or carried out; and

viii) The nature of any connection (whether of a business, family or other nature) between the relevant taxpayer and any person referred to in subparagraph (vi),

802 Braithwaite J, Markets in vice markets in virtue, as above, p152
803 s177D, Income Tax Assessment Act 1936 (Cth)
it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme did so for the purpose of enabling the relevant taxpayer to obtain a tax benefit in connection with the scheme or of enabling the relevant taxpayer and another taxpayer or other taxpayers each to obtain a tax benefit in connection with the scheme (whether or not that person entered into or carried out the scheme or any part of the scheme is the relevant taxpayer or is the other taxpayer or one of the other taxpayers).”

This is a case of rule writers who “hopelessly clutter and complexify the law by seeking to cover all contingencies”.804 The ATO, recognising the hopeless clutter and complexity of the legislation has written a guide to the legislation that is written in clear English and which provides taxpayers with a useful guide to Part IVA.

The ATO guide to Part IVA explains that the anti-avoidance provision will only apply to an arrangement or scheme entered into by a taxpayer if the scheme or arrangement

1. Provided a tax benefit that would not have been available if the scheme had not been entered into, and

2. If after considering the eight matters referred to in s177D (above) it could “be objectively concluded that the taxpayer or any other person entered into or carried out the scheme, or any part of it, for the sole or dominant purpose of obtaining the tax benefit”.805

Although the ATO language is clear and confident, the implementation of this general anti-avoidance section has not been so confident. When conducting interviews for his recent book, Markets in vice markets in virtue, Braithwaite found a view among tax advisors that “the ATO still underestimates the power of Part IVA.”806 Australian professional indemnity insurers in Australia are so convinced of the effectiveness of Part IVA some have recently excluded “from their cover those liabilities that arise from the ATO applying Part IVA to a tax scheme.”807 Braithwaite also found the alternative view about the effectiveness of all general anti-avoidance provisions with many tax experts believing that Part IVA “something of an irrelevance because in jurisdictions that have it the courts rarely apply it, perhaps because they think it opens the door to giving too much discretion to the tax authority.”808

804 Braithwaite J, Markets in vice markets in virtue, as above, p154
805 Australian Taxation Office, Part IVA: the general anti-avoidance rule for income tax, as above, p1
806 Braithwaite J, Markets in vice markets in virtue, as above, p153
807 Ibid
808 Ibid
History of Australia’s General Anti-avoidance Provisions – Part IVA

Australia’s general anti-avoidance provision, Part IVA – Schemes to avoid tax, commenced operation on 24 June 1981. The explanatory memorandum, circulated by the then, Treasurer the Hon. John Howard, stated that the proposed new anti-avoidance provisions replaced the anti-avoidance provision that had been in the ITAA since 1936, the old s260. This provision set out clearly what tax avoidance was and stated that all tax avoidance was “absolutely void”. The old s260 stated that

Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly –

(a) Altering the incidence of any income tax;
(b) Relieving any person from liability to pay any income tax or make any return;
(c) Defeating, evading or avoiding any duty or liability imposed on any person by this Act; or
(d) Preventing the operation of this Act in any respect,

Be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.809

The old s260 appears to be clear, unambiguous and broad in scope. However, as an anti-avoidance provision it proved ineffective because the courts limited the meaning of the section to such an extent that it became “virtually useless in countering tax avoidance”810. Part IVA was inserted specifically to replace the old s260 and to provide an effective general anti-avoidance provision in the tax legislation.

Judicial attitudes to the interpretation of legislation are a significant factor in whether or not legislation produces the results expected by the framers of the legislation. The original anti-avoidance legislation failed in this respect because in “the early to mid-1970’s, Australian courts tended to adopt a strict legalistic interpretation of the tax law, which facilitated the

exploitation of ‘loopholes’, and thus made tax avoidance easier.”811 In his explanatory memorandum to the new Part IVA the then Treasurer of Australia made same the point about the ineffectiveness of the old anti-avoidance provision. He stated

In following a course of interpretation which starts from a position that the section is not to be read literally, the courts have reached a point where, as expressed by a Justice of the High Court in 1977, ‘… the very restricted operation conceded to section 260 by the course of judicial decision and the generality of the language in which the section is expressed stand in high contrast…’812

The text-book writers and the Treasurer both allude to the High Court of the 1970’s as being the obstacle to the effective operation of the old anti-avoidance provision of the tax legislation without mentioning the prime mover in the High Court at the time, the then Chief Justice, Sir Garfield Barwick. Barwick was the Chief Justice of the High Court from 1964 to 1981813.

The highly restrictive approach adopted by the Barwick Court spawned an era of unprecedented tax avoidance, and rampant exploitation of schemes devised to attract the Court’s (tax) base-narrowing precedents. In this era, the Court endorsed a range of blatant avoidance schemes, including arrangements to transfer Australian company profits overseas for tax avoidance purposes (FCT v Commonwealth Aluminium (1980)), and schemes to disguise the non-deductible purchase price of property as deductible rent (FCT v SA Battery Makers (1978)). Among the most infamous of the tax avoidance cases heard by the Court during this period were those in Curran v FCT (1974), FCT v Westraders (1980), and Slutzkin v FCT (1977) – cases involving schemes to strip profits from companies free of any tax. The Court’s endorsement of the schemes – particularly the Slutzkin scheme – led to an explosion of similar arrangements, and ultimately to the illegal ‘bottom-of-the-harbour’ tax evasion phenomena.814

811 Ibid, p1550
813 Blackshield T, Coper M and Williams G (Eds), The Oxford Companion to the High Court of Australia, published by Oxford University Press, Victoria, 2001, p56
814 Ibid, p660
In the dividend stripping case, *Westraders*[^815], Barwick CJ and Murphy J held opposing views as to how tax legislation was to be applied by courts. Barwick CJ, quoting Deane J from the lower Court in upholding the taxpayer’s claim to a deduction, held

> That result may seem both contrary to the general policy of the Act (if it be possible to discern any general policy other than that people pay income tax) and unfair to the ordinary taxpayer who willingly or reluctantly contributes, without resort to tax avoidance, the share of his net income which the Parliament has determined is required by the nation for the common good. If there be, in truth, such contrariety or unfairness, the fault lies with the legislation at the relevant time and not with the courts whose duty it is to apply the words which Parliament has enacted. For a court to arrogate to itself, without legislative warrant, the function of overriding the plain words of the Act in any case where it considers that overall considerations of fairness or some general policy of the Act would be best served by a decision against the taxpayer would be to substitute arbitrary taxation for taxation under the rule of law, and indeed to subvert the rule of law itself.^[816]

Murphy, in response held

> It has been suggested, in the present case, that insistence on a strictly literal interpretation is basic to the maintenance of a free society. In tax cases, the prevailing trend in Australia is now so absolutely literalistic that it has become a disquieting phenomenon. Because of it, scorn for tax decisions is being expressed constantly, not only by legislators who consider that their Acts are being mocked, but even by those who benefit. In my opinion, strictly literal interpretations of a tax Act is an open invitation to artificial and contrived tax avoidance. Progress towards a free society will not be advanced by attributing to Parliament meanings which no one believes it intended so that income tax becomes optional for the rich while remaining compulsory for most income earners. If strict literalism continues to prevail, the legislature may have no practical alternative but to vest tax officials with more and more discretion. This may well lead to tax laws capable, if unchecked, of great oppression.^[817]

[^815]: *Federal Commissioner of Taxation v Westraders Pty Ltd.* [1980] HCA 24
The apparent contradiction between Deane J and Murphy J is reconcilable. The Tax Act did not, in Deane’s words, provide ‘any general policy’ for the courts to interpret. Murphy himself held that the tax Act was written in language “such that it is impossible to express without bewildering complexity provisions which preclude the abuse of a strict literalist approach.”\(^{818}\) In fact “in the income tax sphere, there was no obvious purpose in much of the law. In all the key policy areas, the legislature had abdicated responsibility entirely to the judiciary. In effect, the legislature had implicitly endorsed wholly irrational distinctions, such as reliance on trust law notions to determine which profits should bear tax and which expenses should be deductible.”\(^{819}\)

The difficulty of finding a general purpose in the Australian income tax legislation does not, however, in my opinion, excuse or provide sufficient excuse for the Barwick court to dismember\(^ {820}\) the anti-avoidance provision (s260) that had worked “moderately well”\(^ {821}\) for sixty years.

This emasculation of the original anti-avoidance provisions led to the replacement general anti-avoidance provisions of Part IVA of the tax Act in 1981\(^ {822}\). 1981 was also the year that Barwick retired from the High Court and replaced by Gibbs CJ. In one of his first judgements in taxation matter of 1981 Gibbs CJ signalled that the newly constituted High Court would be using a more purposive approach to interpreting tax legislation than the previous Court. Gibbs CJ held that

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\text{It is an elementary and fundamental principle that the object of the court, in interpreting a statute, ‘is to see what is the intention expressed by the words used’: River Wear Commissioners v. Adamson (1877) 2 App Cas 743, at 763. It is only by considering the meaning of the words used by the legislature that the court can ascertain its intention.} \quad ^{823}\]

Gibbs CJ was interpreting a section of the tax Act that was in operation when Barwick was the Chief Justice. Gibbs CJ had no difficulty in distinguishing between transactions that in

\(^{818}\) [1980] HCA 24 at Murphy [10]  
\(^{819}\) Blackshield T, Coper M and Williams G (Eds), *The Oxford Companion to the High Court of Australia*, as above, p661  
\(^{820}\) Ibid  
\(^{821}\) Ibid  
\(^{822}\) Ibid  
form and substance gave rise to a deductible expense and where “conditions of deductibility would be fulfilled in form but not in substance.” 824

Tax Avoidance and Tax Planning

The introduction of effective general anti-avoidance provisions in Australian tax legislation and a willingness by the courts to interpret those provisions in a purposive way has lessened the difference between tax evasion and tax avoidance so that there is no longer a meaningful difference between them. However, Australian tax legislation still leaves scope for large-scale tax planning by sophisticated taxpayers.

In a UK case, *IR Commissioners v Willoughby* 825, the distinction between tax avoidance and tax planning, also called tax mitigation, was clearly defined by Lord Nolan who held that

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability. The hallmark of tax mitigation, on the other hand, is that the taxpayer takes advantage of a fiscally attractive option afforded to him by the tax legislation, and genuinely suffers the economic consequences that Parliament intended to be suffered by those taking advantage of the option. 826

The difference between tax avoidance and tax planning is thus another fine line drawn by the judiciary. In practice the difference between tax avoidance and tax planning is very difficult to distinguish. This practical difficulty is illustrated by the treatment of a common tax planning device, the tax scheme.

Tax Schemes

Tax schemes promoted to reduce tax liability have been common in Australia since the 1970’s. Tax schemes, typically, involve the taxpayer making a large, tax deductible ‘investment’ in a scheme which will never make a profit, but which will generate large tax losses for the investors. Typical schemes were and are investments in films, pine plantations, research and development etc.

826 Ibid, from *IR Commissioners v Willoughby*, [1997] 4 All ER 65 at 73
Schemes work to give taxpayers a tax deduction greater than their actual cash outlay. Typically, if a taxpayer spends $1 on a tax deductible item the tax deduction is $1. In tax schemes a taxpayer can spend $1 and obtain a tax deduction of greater than the $1 actually spent. Tax schemes involve a taxpayer making an investment using a small amount of their own funds plus a large component of borrowed funds. The taxpayer is given a deduction for the total amount invested in the scheme, plus a deduction for the borrowing costs associated with the borrowed funds. A Senate enquiry into mass marketed schemes reported that;

To illustrate the aggressive nature of these schemes, the ATO cited as ‘typical’ an example where a taxpayer in the top marginal rate acquires a tax saving of $14,000 for a cash outlay of $10,000. In other words, in addition to the tax system refunding the initial $10,000 investment, the taxpayer in this scenario receives ‘a bonus of $4,000’.

Promoters of schemes can obtain rulings from the Australian Tax Office to attest to the legality of the scheme being promoted. Legality in this context means certainty that taxpayers investing in the scheme will be able to obtain a tax deduction for the value of their investment. Investors in such schemes need to “examine the ruling carefully to ensure the arrangement described in the ruling is in exactly the same terms as that promoted. Any change or variation in the nature or terms of the arrangement would remove the protection accorded by the ruling.”

Up until 2006 promoters of tax schemes, which get paid by taxpayers using the schemes, had no legal responsibility if the schemes were not acceptable to the Tax Office. In that case the taxpayers were liable for any taxation held to have been avoided, and may be liable to pay hefty penalties for any tax attempted to be avoided. In order to make promoters of these failed schemes accept some responsibility for the products they are selling the government announced, in December 2003, “the government’s intention to introduce a civil penalty regime to deter the promotion of tax exploitation schemes.” The draft legislation was introduced into the House of Representatives on 16 February 2006 as the Tax Laws Amendment (2006 Measures No. 1) Bill 2006. The Bill, among other matters, introduced a

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828 Woellner RH, Barkoczy S, Murphy S and Evans E, Australian Taxation Law, as above, p1552
829 Ibid, p1554
830 Bills List, Senate Table Office, published by the Parliament of the Commonwealth of Australia, 17 February 2006, p24
new Div 290 into the TAA\textsuperscript{831} which imposes, for the first time, penalties for promoters and implementers of tax exploitation schemes. The legislation permits the Taxation Commissioner to impose a “civil penalty, injunction or enforceable undertaking”\textsuperscript{832} on promoters of tax exploitation schemes that do not conform to the ATO product ruling. The Federal Court may impose an injunction or a penalty. The maximum penalty the court can impose “is the greater of 5,000 penalty units (currently equal to $550,000) for an individual or 25,000 penalty units (currently equal to $2.75m) for a body corporate and twice the consideration received or receivable, directly or indirectly, by the entity or its associates in respect of the scheme.”\textsuperscript{833}

As a result of the enquiry into mass marketed schemes the ATO established a ‘promoter taskforce’ to pursue and prosecute promoters of illegal tax schemes established with the primary purpose of avoiding tax. In July 2002 the ATO announced that it was increasing its tax promoter taskforce from “25 to around 55 officers.”\textsuperscript{834} At the same time the ATO announced an amnesty for people who invested in mass market schemes. The amnesty means that “most investors will not be charged penalties or interest and will be allowed deductions for the actual cash they paid into eligible (for the amnesty) schemes. Typically this is around 25 per cent of the deduction claimed.”\textsuperscript{835}

Since the introduction of the new legislation to control tax exploitation schemes and their promoters there have been no convictions of any scheme promoters\textsuperscript{836}. The legislation may therefore have stopped unscrupulous promoters of tax minimisation schemes or, the legislation is ineffective. As well as this uncertainty about the effectiveness of the new legislation there is difficulty in quantifying the value of tax receipts lost through the use of tax schemes.

In 2002 when the ATO introduced the amnesty for people who had participated in tax schemes the ATO stated, “right now we have 150 promoters under review including one case involving a promoter who sold four schemes to around 500 participants who claimed more than $500 million in deductions.”\textsuperscript{837} The 2002 amnesty offered to taxpayers who had

\textsuperscript{831} Tax Administration Act 1953 (Cth)
\textsuperscript{833} Ibid, p1608
\textsuperscript{835} Ibid
\textsuperscript{836} This is to the date of writing, 13/02/2008
\textsuperscript{837} Australian Taxation Office, ‘Tax Office Announces Settlement Offer for Mass Marketed Scheme Investors’, as above
participated in tax schemes resulted in “87 per cent of investors in mass marketed tax schemes”\textsuperscript{838} accepting the ATO settlement offer, this was 36,000 people\textsuperscript{839}. In 2002 the Australian Parliament issued its final report of the Senate Economics References Committee \textit{Inquiry into mass marketed tax effective schemes and investor protection}.\textsuperscript{840} The enquiry estimated that at 30 June 1999 the use of mass marketed schemes had cost Australia $1.5 billion in overstated tax deductions. “At 30 June 1999, the ATO had finalised its position on 134 schemes, disallowing tax deductions worth $1.5 billion claimed by 22,000 taxpayers. The ATO forecasts finalising in 1999-2000 a further 120 schemes involving 36,000 investors and the disallowance of potentially $2 billion in deductions.”\textsuperscript{841} If the disallowed deductions and the potentially disallowed were all subject to the top marginal person rate of taxation of 45\% then the cost to taxation revenue was $1.575 billion. However, this is only an estimate of cost relating to mass marketed schemes. There are no figures for the impact on taxation revenue through the operation of ‘boutique’ schemes tailored for high net wealth individuals by their financial advisors.

\textbf{Transfer Pricing Defined}

Any individual can enter into a tax scheme to minimise their taxes and, as can be seen, the potential cost to Australian tax revenue could be in excess of $1.575 billion. However, only corporations can take advantage of transfer pricing to minimise taxes. The cost to taxation revenue by the use of transfer pricing by multi-nationals operating in Australia is far greater than the cost of individuals using tax schemes.

When goods and services are traded between related companies the prices charged for those goods and services is the transfer price. Transfer pricing is the mechanism used by these related companies to value the good or service trading between them. In this way profits and losses may be allocated between companies in a group by simply adjusting the price charged for goods and services ‘sold’ between group members. This profit shifting between group companies is irrelevant if all the companies in the group are taxed in the same jurisdiction. However, if one of the group companies operates in a different taxing jurisdiction, groups of companies can use transfer pricing to shift profits from high taxing jurisdictions to low company taxing jurisdictions.

\textsuperscript{839} Ibid
\textsuperscript{841} Ibid, Chapter 4, p31
An Australian example of transfer pricing considered by the High Court in 1964 was *Cecil Bros Pty Ltd v Federal Commissioner of Taxation*842 (‘Cecil Bros’). The taxpayer, Cecil Bros carried on business as a shoe retailer who, prior to the tax year in question, had purchased its trading stock from independent wholesalers. In the year in question the taxpayer purchased some of its retail stock from a related company, Breckler Pty Ltd (‘Breckler’), at mark-ups of around 10% of the normal wholesale price. Breckler was a company whose shareholders were the children and grandchildren of the shareholders in Cecil Bros. The intent of establishing Breckler was to provide income for these children. In effect Cecil Bros paid inflated prices for trading stock so that its own income was reduced by £19,777 and the income of Breckler was increased by the same amount. The Tax Commissioner denied Cecil Bros a deduction for the inflated cost of trading stock and attempted to void the arrangement between the taxpayer and Breckler using the then anti avoidance provision s260 ITAA36843. The full High Court, Menzies J held

That it was at all material times open to the taxpayer company to buy directly from its usual suppliers at lower prices or to order its requirements from Breckler Pty Ltd at higher prices so that the latter could make profits. When it bought from Breckler Pty Ltd, therefore, it chose to pay more than was necessary for the purpose of allowing that company to make a profit.844

In other words, it is perfectly legal for companies in a group of companies to decide in which company the profits will be made. In the above case both related companies were located in Australia a single taxing jurisdiction. In this instance the effect on tax collections is nil, because Breckler would be paying taxes on the transfer profit of £19,777 and Cecil Bros would be claiming a tax deduction of £19,777 from its profits. However, if the group companies were in different tax jurisdictions then one jurisdiction would be denied revenue at the expense of the other jurisdiction.

After the decision in *Cecil Bros Pty Ltd* the Australian tax legislation was changed to deal with non-arms length transactions such as those undertaken by Cecil Bros and Breckler Pty Ltd845. The legislation requires any non-arms length trading stock transaction to be treated as

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842 (1964) 111 CLR 430
844 *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 at 440
845 ITAA97 s70-20 deals with non-arms length trading stock transactions and imposes market values on such transactions.
though the transaction is an arms-length transaction, that is, market prices are to be substituted for any prices that are not market prices. In essence, international transfer pricing rules attempt the same outcome as this piece of legislation.

International transfer pricing is when transfer prices are allocated to goods and services between related companies operating internationally. A standard university tax law text states “transfer pricing is used by multinational enterprises as a method of siphoning off profits from a company in a high tax rate country to a related company in a low tax rate country.”\textsuperscript{846} Even though this text defines transfer pricing as being all about avoiding tax, transfer pricing is not even mentioned in the chapter discussing tax avoidance. This treatment is typical in Australian taxation texts for undergraduate law and accounting students.

**Transfer Pricing Defined**

Transfer pricing is any arrangement under which profits are shifted out of one taxing jurisdiction to another, “primarily through the mechanism of inter-company and intra-company transfer pricing.”\textsuperscript{847} Profit shifting between jurisdictions, as seen below, is the largest single component used by corporations to evade and avoid tax. Terms commonly used in the context of transfer pricing are, intercompany trade, trade between related companies and intra-firm trade.

- Inter company trade is when property or services are acquired or disposed of under an international agreement between separate legal entities that are, however, all members of the same group of companies with a common parent company.
- Trade between related companies is when property or services are acquired or disposed of under an international agreement between separate legal entities that are, however, companies related by common ownership or control.
- Intra-firm trade is the internal dealings of a multinational enterprise, that is, “dealings between the head office and a branch (permanent establishment) or between branches”\textsuperscript{848} in order to shift profits from one taxing jurisdiction to another.

**Impact of Transfer Pricing**

\textsuperscript{846} Ibid, p1461
\textsuperscript{848} Ibid, p1348
In his book, *Capitalism’s Achilles Heel*, author Baker believes that capitalism is under threat because of what he calls ‘dirty money’, that is “money that is illegally earned, illegally transferred, or illegally utilized.” Baker has identified three types of dirty money:

1. **Criminal money** from global organised crime including the trade in illicit drugs, counterfeit goods, human trafficking, the illegal arms trade, unrecorded oil sales, illegal timber and the cross-border traffic in stolen goods such as cars and, cigarettes, endangered species, gems, art and antiques. Baker estimates that cross-border criminal proceeds are in the range of $US50 billion to $US100 billion annually.

2. **Corrupt money**, “the cross-border flows of corrupt proceeds, taken as local bribes remitted abroad or as bribes paid abroad.” Even though Baker estimates that corrupt money “is by far the smallest of the three components of cross-border dirty money … it has an influence on a society well beyond its size.” Baker estimates that cross-border flows of corrupt proceeds “transferred out of just 20 developing and transitional economies” are in the range of $US20 billion to $US40 billion annually. Baker excluded the corrupt proceeds that stay within a country because “at least it gets recycled locally, even if only in the lifestyles of greedy officials.”

3. **Commercial tax-evading money through**
   a. mispricing,
   b. abusive transfer pricing and
   c. a broad range of other tax evasion methods using fake transactions.

Mispricing is when goods or services are sold between non-related enterprises and mispriced “in order to generate kickbacks into foreign bank accounts.” A recent example of mispricing in Australia was discovered in 2005 when Australia’s monopoly wheat board, the Australian Wheat Board (‘AWB’) was discovered to have “paid nearly $300 million in so-called ‘trucking fees’ to a company now exposed as a front for Saddam Hussein.” The $300 million trucking fees were found to be bribes paid to the Hussein government to enable the AWB to sell $1 billion of wheat into Iraq.

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849 Baker RW, *Capitalism’s Achilles Heel*, as above, p23
850 Ibid, p 166
851 Ibid, pp166-168
852 Ibid, p168
853 Ibid
854 Ibid, p169
855 Ibid, p168
856 Ibid
857 Ibid
858 Ibid
859 Ibid
860 Grimm N, ‘Govt drawn into AWB kickbacks affair’, *The 7.30 Report*, Australian Broadcasting Commission, broadcast 17/1/2006, [http://www.abc.net.au/7.30/content/2006/s1549627.htm](http://www.abc.net.au/7.30/content/2006/s1549627.htm), accessed 13/02/08
Transfer pricing is the same device as mispricing but occurs between related companies in order to shift profits around the globe. “Transfer pricing is used by virtually every multinational corporation to shift profits at will around the globe.” Of all the techniques to move dirty money around the world, Baker estimates that transfer pricing is the largest single component.

Fake transactions involve “billing and receiving payment for goods and services never delivered”:

Included in this category are “fake or vastly exaggerated charges for services, royalties, patents, trademarks, advertising, consulting, management contracts, software updates, insurance policies, and countless other subterfuges.”

Baker believes that dirty money “totalling trillions of dollars … poses a major risk to state stability, corporate security, democracy, and free enterprise across the planet.” He has conservatively estimated the amount of dirty money flowing annually across borders.

Table 3

Cross-Border Flows of Global Dirty Money in US$ Billions

<table>
<thead>
<tr>
<th>Category of Dirty Money</th>
<th>High Estimate</th>
<th>Low Estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Criminal</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Drugs</td>
<td>200</td>
<td>120</td>
</tr>
<tr>
<td>Counterfeit Goods</td>
<td>120</td>
<td>80</td>
</tr>
<tr>
<td>Counterfeit Currency</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Human Trafficking</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>Illegal Arms Trade</td>
<td>10</td>
<td>6</td>
</tr>
<tr>
<td>Smuggling</td>
<td>100</td>
<td>60</td>
</tr>
<tr>
<td>Racketeering</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td><strong>Total Criminal</strong></td>
<td><strong>549</strong></td>
<td><strong>331</strong></td>
</tr>
<tr>
<td><strong>Corrupt</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>50</td>
<td>30</td>
</tr>
<tr>
<td><strong>Commercial</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mispicing</td>
<td>250</td>
<td>200</td>
</tr>
<tr>
<td>Abusive Transfer Pricing</td>
<td>500</td>
<td>300</td>
</tr>
<tr>
<td>Fake Transactions</td>
<td>250</td>
<td>200</td>
</tr>
<tr>
<td><strong>Total Commercial</strong></td>
<td><strong>1,000</strong></td>
<td><strong>700</strong></td>
</tr>
</tbody>
</table>

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861 Baker RW, *Capitalism’s Achilles Heel*, as above, p170
862 Ibid, p171
863 Ibid
864 Ibid, p22
865 Ibid, p172
Over 60% of the value of dirty money flowing across the globe does so under the guise/protection of commercial corporate interests. Abusive transfer pricing alone accounts for one third of all dirty money.

The Australian Taxation Office (‘ATO’) calculated, that as far as Australia was concerned, in the 1998 financial year

the value of related party international transactions was $76 billion, excluding loans. This comprises purchases and expenditure of $45 billion and sales of $31 billion. Both these figures relate to the value on the Australian side of the cross-border dealings. The combined value of cross-border related party loans is around $62 billion, being borrowings of $37.5 billion and loans of $24.5 billion.\textsuperscript{866}

In 1998-99 Australia’s GDP was $593 billion.\textsuperscript{867} The $76 billion of related party cross-border transactions is 13% of Australia’s GDP for that year. Even though the amount of related party cross-border transactions is not directly comparable to Australia’s GDP it does give an image of the size and significance of these transactions to the Australian economy. If only 10 per cent of these trading and intercompany lending transactions were mispriced then Australian profits could be misstated by over $7 billion.

This Australian total of cross-border related party transactions would not all be in the category of abusive transfer pricing. However, comparing the Australian total of related cross-border related party transactions of $76 billion, with the world-wide total of abusive transfer pricing arrived at by Baker, (of between $US300 billion to $US500 billion) the Baker estimate does not seem to be exaggerated.

After reading the Baker analysis of cross-border dirty money it becomes unsurprising that the Deputy Commissioner (Large Business and International) ATO would be making a speech on transfer pricing to a conference on international crime. The boundaries of normal corporate practice and international crime appear to be narrowing, just as the distinction between tax avoidance and tax evasion has narrowed.


\textsuperscript{867} Australian Bureau of Statistics, 2001 Year Book Australia, published by the Australian Bureau of Statistics, Canberra, 2001, p973
The Australian Response to Transfer Pricing

The Australian Taxation Office (‘ATO’) established its international division in 1993\textsuperscript{868} to deal with the adverse effects that globalisation were having on taxation revenues. Jim Killaly, the then Deputy Commissioner (Large Business and International) ATO, stated “all the risk factors for significant underpayments of tax were there”\textsuperscript{869}. The significant factors identified by Killaly were

- The amounts involved were very significant,
- There were no established methodologies acceptable to the revenue authorities for valuing related party cross-border transactions,
- It was not known whether or not taxpayers were getting transfer pricing wrong because “they did not know how to develop and apply a methodology, or because they were intent on shifting profits to low tax or home jurisdictions,”\textsuperscript{870} and
- Some taxpayers “were seeking to conceal income derivation or the nature of their dealings through tax haven entities which can also serve as anonymous repositories for assets.”\textsuperscript{871}

Since the establishment of the international division by the ATO the ATO has released a number of Taxation Rulings with respect to transfer pricing as well as a number of guidelines as to how those rulings are to be put into practice. The rulings are

- **TR94/14**\textsuperscript{872}
  Income tax: application of Division 13 of Part III (international profit shifting) – some basic concepts underlying the operation of Division 13 and some circumstances in which section 136AD will be applied
- **TR95/23**
  Income tax: transfer pricing – procedures for bilateral and unilateral advance pricing arrangements other rulings on this topic TR94/14
- **TR97/20**
  Income Tax: arm’s length transfer pricing methodologies for international dealings
- **TR98/11**

\textsuperscript{868} Killaly J, ‘Compliance Issues and Insights in the Context of Global Profit Allocation’, as above, p1 of 6
\textsuperscript{869} Ibid
\textsuperscript{870} Ibid
\textsuperscript{871} Ibid, pp1 and 2
\textsuperscript{872} Tax Office rulings are numbered by their year of release, followed by the number representing the chronological release for the year. TR94/14 is therefore, the 14\textsuperscript{th} ruling released in 1994. Taxation rulings have the force of law if released after 1997. Before 1997 tax rulings only represent the views of the ATO.
Income tax: documentation and practical issues associated with setting and reviewing transfer pricing
- TR98/16

Income tax: international transfer pricing – penalty tax guidelines

The most important ruling is TR97/20, because it sets out the methodologies acceptable to the ATO for valuing cross-border intercompany transactions. The ruling attempts to ensure that multinational companies pay a reasonable amount of tax in the jurisdiction that they earn taxable income. The ruling states the objective thus:

Applying the arm’s length principle leads to a calculation of the taxable income that might reasonably be expected to be derived if the parties were dealing at arm’s length with each other.¹⁸⁷³

The ruling has a modest objective, that is, to be able to calculate the taxable income of a multinational ‘reasonably’.

Taxation Ruling 97/20

TR 97/20 sets out Australia’s transfer pricing rules that apply to international dealings between separate legal but related entities. The ruling sets out in detail the arm’s length pricing “methodologies acceptable to the ATO and when they are considered appropriate.”¹⁸⁷⁴

The arm’s length pricing principles are applicable to all dealings, including intangibles, the provision of all intercompany services and cost contribution arrangements¹⁸⁷⁵. The Ruling accepts the principles of The Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations promulgated by the OECD in 1995 but there are some minor “differences in emphasis or extensions of OECD principles”¹⁸⁷⁶.

The ruling sets out in considerable detail the acceptable methodologies for determining arm’s length prices, how to implement the different methodologies, for which type of transaction and even the documentation required to support the use of a particular methodology. The Ruling is technically detailed and replete with rules and procedures. For example, Chapter 3 of the Ruling covers the various arm’s length methodologies.

¹⁸⁷³ TR 97/20, ‘Income tax: arm’s length transfer pricing methodologies for international dealings’, para 1
¹⁸⁷⁴ Ibid, para 3
¹⁸⁷⁵ Ibid, para 4
¹⁸⁷⁶ Ibid, paras 6 and 7
3.1 There are a number of internationally accepted methodologies that test compliance with the arm’s length principle. These arm’s length methodologies are divided into two groups:

(1) The traditional transaction methods (‘traditional methods’) being:
   a) The comparable uncontrolled price method (CUP) method;
   b) The resale price (RP) method; and
   c) The cost plus (CP) method; and

(2) The transactional profit methods, which include the profit split methods and transactional net margin methods (‘profit methods’).\textsuperscript{877}

The CUP method “compares the price for the property or service transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances.”\textsuperscript{878}

TR 97/20 recognises difficulties in implementing the CUP method as “geographic differences in the markets, the terms of the contractual arrangements (such as volumes, discounts, interest free periods, and exchange rate exposure), the particular time period of the contracts, or differences in the physical/chemical features of the commodity and the relative bargaining power and strategies of buyers and sellers. Business strategies like price competition and marketing intangibles like brand names can also impact on prices.”\textsuperscript{879}

Other difficulties in implementing the CUP method not mentioned in the ruling include:

- Since half of world trade is between related companies it would be practically impossible to locate ‘comparable uncontrolled transaction in comparable circumstances’ in most cases. This would be especially difficult in the case of intercompany lending and borrowing and trading in intangibles.
- When attempting to use this methodology for trading in goods, each company would have unique requirements when it came to trading in work in process type goods.
- When trading in finished goods the existence of oligopolies in most major industries would mean there would be very few uncontrolled prices for comparison. The industries that operate in oligopoly include pharmaceuticals, petroleum products, seeds, fertilizers, motor vehicles, avionics, infrastructure providers, computer providers and media.

\textsuperscript{877} Ibid, para 3.1
\textsuperscript{878} Ibid, para 3.11
\textsuperscript{879} Ibid, para 3.14
• If there were uncontrolled prices, there would also be a difficulty in obtaining them from potential competitors because of commercial in confidence.

The RP method is “based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm’s length price of the original transfer of property between the associated enterprises.”

TR 97/20 recognises the difficulty in applying the RP method as the difficulties in determining an appropriate resale price margin. The Ruling states that “the appropriate margin would be expected to vary according to the amount of value added by the reseller.”

The value added by the reseller would be expected to vary according to the risks undertaken by the seller such as warehousing risk, advertising expenses, other marketing commitments related to the product, warranty, product education and, other product risks such as obsolescence and fashion changes.

Other difficulties in implementing the RP method not mentioned in the Ruling include:
• Establishing an appropriate sales price margin if only a minor part of the trade is external to the group. This would effectively allow the group company to set an ‘appropriate’ sales margin for the group by selling goods externally at any price that gives the group the profit result it requires for tax or other purposes.
• Establishing an appropriate sales price margin in an oligopolistic situation. Again, in this situation the corporations in the market could set prices and determine an ‘appropriate’ sales margin.

The CP method “begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost mark up is then added to this cost, to make an appropriate profit in light of the functions performed and the market conditions.”

880 Ibid, para 3.20
881 Ibid, para 3.28
882 Ibid, paras 3.28 to 3.30
883 Ibid, para 3.31
TR 97/20 recognises the difficulty in applying the CP method as the problems of choosing which costs to mark up, how to identify the direct costs of production and finding an acceptable basis for apportioning the indirect costs of production\textsuperscript{884}.

Other difficulties in implementing the CP method not mentioned in the Ruling include:

- Gaining access to the necessary accounting records of the related company because of commercial in confidence issues.
- If the accounting records have been supplied, there would be problems interpreting the records due to language and cultural differences as well as differences in accounting rules between jurisdictions.
- Establishing appropriate costs in an oligopolistic situation. As above, in this situation the corporations in the market could set prices and determine appropriate ‘costs’ and therefore determine their own profits.

TR 97/20 acknowledges that the above traditional, transaction based methods for establishing arm’s length prices might be impossible or impractical to apply because of the fact that “global industries are based on highly sophisticated technology, involve valuable production, distribution or marketing intangibles and are generally vertically and horizontally integrated. The global networks in such industries are complex, they have their own unique structures and products that may have been supplied by a number of associated enterprises.”\textsuperscript{885} In these cases the Ruling recommends the use of ‘profit methods’ to estimate an appropriate profit that should result from intercompany dealings. This acknowledgment of the difficulty of trying to find comparable arm’s length transactions in order to determine a ‘market price’ for intercompany transactions is an acknowledgement that competitive free markets no longer exist for many intercompany transactions. The Ruling details profit methods that can be applied to inter company dealings and the guiding principle in applying these methods is to apply a method “that makes commercial sense in the circumstances of the case.”\textsuperscript{886}

TR 97/20 provides transfer pricing rules, guidelines for adoption of those rules, requirements as to documentation all in some detail. And even though the rules seem definitive the ATO recognises that “transfer pricing is not a precise science and applying the concepts requires some flexibility to produce a result that reflects the underlying purpose of the statutory provisions…. There may be gaps in information and data for both taxpayers and the ATO.

\textsuperscript{884} Ibid, paras 3.33 to 3.51
\textsuperscript{885} Ibid, para 3.52
\textsuperscript{886} Ibid, para 3.55
that need to be acknowledged in making judgments. The effort required of a taxpayer varies depending on the importance of the transfer pricing issue and what a reasonable business person might be expected to do in similar circumstances.”

Allowing firms to use profit methods to determine the value of intercompany transactions is allowing firms to set their own profits. Galbraith recognised that in the new industrial state (in chapter 3 of this thesis) of large corporations it is the corporations and not markets that set prices, production levels, goods produced and of course profit levels.

The modern corporation, in establishing their profits are assisted by the major accounting firms, all of whom offer advice on transfer pricing as a tool for reducing their client’s effective global tax rate.

The Transfer Pricing Industry

All major international accounting firms have transfer pricing divisions that are employed by multinational clients to get the most out of the transfer pricing rules.

Ernst & Young’s transfer pricing group worldwide has “more than 400 highly respected professionals use their understanding and insights into country tax laws, regulations, rulings, methods and requirements to serve multi-national clients around the world.” Ernst & Young holds transfer pricing events. For example, a seminar held in Australia on 7 July 2006, the second of a series of seminars, discussed the substantial potential benefits of tax effective supply chain planning. “The event was attended by around 35 delegates and the speakers outlined the issues and potential benefits of supply chain optimisation whether this takes the form of a full supply chain reorganisation or whether only certain parts of the supply chain are reorganised.” Supply chain optimisation is really how best to move profits along the supply chain in your business in order to maximise the corporations’ goals. Those goals can include maximising profits and minimising tax.

Price Waterhouse Coopers has their transfer pricing department located in their tax services area acknowledging that transfer pricing is not about allocating profits between companies in a group but about allocating taxation between companies in a group. Price Waterhouse

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887 Ibid, para 1.1
890 Ibid
891 http://www.pwc.com/extweb/service.nsf/docid/CCC888378E3DB22ECA256CE700097497, accessed 14/02/08
Coopers offers their clients and potential clients help in “managing transfer pricing risk”.

The risk is seen to come from the ATO who “continued to stress its focus on transfer pricing and is currently considering adjustments which, in aggregate, amount to billions of dollars. Taxpayers will continue to face regular investigations from the regulator as transfer pricing is included as an integral component of the risk reviews being rolled out under the ATO’s co-operative compliance program.” In other words, Price Waterhouse Coopers will help corporations deal with the ATO in order to achieve the transfer pricing arrangements that best suit the corporation. Price Waterhouse Coopers advertise that they “will work with you to ensure your organisation’s international financial position is effectively managed and your fiscal risk covered, and together we will put your company in the best possible position to take advantage of the benefits of globalisation and international structuring.”

KPMG has a transfer pricing group called Global Transfer Pricing Services and they use clear language to tell their clients and potential clients that the objective of the KPMG service is to help clients comply with national transfer pricing rules in order to “reduce their effective global tax rate”.

KPMG states that “Transfer pricing rules have become a very important tactic for a growing number of jurisdictions in retaining tax revenues that might otherwise migrate to another country. Multinationals often strive to reduce their effective global tax rate, while being bound by widely differing local tax rules. Furthermore, the way these rules are applied can be very different from the transfer pricing principles set out by the OECD.” KPMG states that they help our firms’ clients:

- Develop and implement commercially realistic and fiscally efficient transfer pricing policies
- Modify or change those policies when new rules or circumstances emerge
- Prepare and maintain the associated transfer pricing documentation - often with the help of Interpreter® our Web-based transfer pricing technology
- Put together well-argued and documented responses to challenges by the tax authorities, supported by economic justifications of existing principles and prices.

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892 Ibid
893 Ibid
894 Ibid
895 http://www.kpmg.com/services/tax/business/transfer, accessed 14/02/08
896 Ibid
897 Ibid
KPMG worldwide ‘employs more than 900 transfer pricing professionals, supported by thousands more tax professionals in KPMG’s network of member firms. Comprising economists, tax practitioners, financial analysts and, where permitted under local legislation, lawyers, the GTPS group provides our firms’ clients with local resources that operate in a truly global network.’\textsuperscript{898}

In other words KPMG will, as the other firms will, help their clients use transfer pricing rules in order to minimise their client’s tax bills. The large international accounting firms, as can be seen from the above examples, are aggressive in pursuing transfer pricing business. They devote considerable resources to support their clients in successfully minimising their tax expense. The transfer pricing rules, as shown above, effectively allow multinationals to decide what their profits will be and thus, effectively determine their own tax expense.

Having looked at the advertised goals of the accounting industry with respect to transfer pricing it is clear that the industry;
1. holds the taxing authorities as being in an adversarial position to their clients and seeks to advocate on behalf of their clients,
2. seeks to provide their clients with tax minimisation strategies that will ‘pass’ the scrutiny of the taxing authorities, and
3. devotes considerable professional staffing resources to this task.

**Taxing Authority Response**

National taxing authorities are, in Australia at least, not sufficiently well resourced to be able to audit all corporations’ compliance with the transfer pricing rules. The ATO approached the compliance issue with a Transfer Pricing Record Review and Improvement Project (‘the Project’) shortly after the transfer pricing rulings were promulgated\textsuperscript{899} in 1998. The Project used a ‘meta-management’ approach to assess the risk to taxation revenue of firms not complying with the transfer pricing rules. Meta-management under the Project meant that the ATO “widely distributed three booklets on the new approach (meta-management), sent letters to relevant companies, and conducted a number of public seminars and private seminars for the clients of major accounting firms. There were also consultation meetings with the transfer pricing partners of the Big Five accounting firms.”\textsuperscript{900}

\textsuperscript{898} Ibid
\textsuperscript{899} Braithwaite J, *Markets in vice markets in virtue*, published by The Federation Press, Australia, 2005, p90
\textsuperscript{900} Ibid, p91
The ATO then selected one hundred and ninety companies for a risk assessment audit by the ATO. The selected companies had a “total income between $50 million and $500 million and at least $30 million in international related party transactions.”\(^{901}\) In other words, at least $5.7\(^{902}\) billion worth of related party transactions. At the end of the Project these companies were ranked into a hierarchy of risk management responses. The hierarchy was assessed by the ATO on the basis of the quality of the selected company’s “transfer pricing processes and documentation … and whether their profits were commercially realistic or less than commercially realistic.”\(^{903}\)

The hierarchy of risk management\(^{904}\) at the end of the review was;

1. 22 Low risk companies dropped from the programme
2. 56 Modest risk companies who received a letter with no further action by the ATO
3. 34 Medium risk companies who were asked to supply a “letter of explanation advising how your company’s current transfer pricing practices and documentation comply with the arms’ length principle”\(^{905}\)
4. 32 Medium-high risk companies “who were told they clearly had a problem and would be subject to another TPRR (transfer pricing review) for their next return”\(^{906}\) and,
5. 46 High risk companies who would be subject to an ATO audit

This Project was undertaken in 1999 and, by the year 2002 the ATO in its compliance programme scheduled “to complete 30 transfer pricing audits”\(^{907}\) of large businesses. The ATO is therefore, continuing to audit compliance with transfer pricing rules. In order to put the extent of the programme into perspective in the year 2003-04 the ATO had classified 1,488\(^{908}\) taxpayer enterprises in the category of ‘large’\(^{909}\) and so an audit of 30 large companies is an audit of 2% of large enterprises and, at 30 companies a year, it would take the ATO 50 years to audit all large enterprises for transfer pricing. The initial risk reviews undertaken by the ATO identified that just under a quarter of the large companies selected

\(^{901}\) Ibid
\(^{902}\) $5.7 billion = 190 companies x $30 million international related party transactions
\(^{903}\) Braithwaite J, *Markets in vice markets in virtue*, as above, p91
\(^{904}\) Ibid, p91
\(^{905}\) Ibid, pp90-91
\(^{906}\) Ibid, p91
\(^{909}\) A ‘large’ enterprise is defined for the purposes of ATO classification as large if it has a total annual income of more than $100 million.
were considered ‘high’ risk. Even though many large companies would have improved their transfer pricing practices in order to conform to ATO rules since the initial review, considering the risk to tax revenue from abusive transfer pricing policies, an audit of large 30 companies in a year is minimal.

There was evidence that companies had improved their transfer pricing practices since the ATO commenced the transfer pricing project in 1998: “the tax paid by companies in the programme jumped much more sharply in the post review year, 1998, to be 139 per cent higher in the post-intervention year than the pre-intervention year.”

The ATO has reported that small and medium sized firms are increasingly engaging in transfer pricing activities. 910 In 2002 the ATO reported that “approximately 8% of small to medium enterprises have ‘related party’ international dealings valued at more than $5 billion. Over the last three years, the average value of each transaction has increased by 640% to $2.7 million.” 911 During the year ended 30 June 2003 the ATO planned to conduct a “risk assessment of the transfer pricing policies of 40 high-risk small to medium enterprises.” 912 In the year 2003-04 the ATO had classified 49,044 913 businesses as small to medium 914. The ATO has estimated that 8% of small to medium enterprises are engaging in international related party dealings, that would be approximately 3,900 enterprises and so, a review of 40 of them represents a review of 1% of small to medium enterprises engaging in transfer pricing activity. Even though the 40 enterprises subject to the ATO review represent those considered to be ‘high-risk’ it still represents a very small percentage of relevant enterprises.

Conclusion

Over 60% of international trade is estimated to be intercompany trade. This means that there are no longer competitive markets in many goods and services so as to be able to determine ‘arms length’ prices for goods and services. Given the dominance of oligopoly firms it would also be impossible to determine whether reported ‘profits were commercially realistic or less

911 Ibid, p14 of 28
912 Ibid
913 Australian Taxation Office, Taxation Statistics 2004-05, as above, p27
914 A ‘small’ enterprise is defined for the purposes of ATO classification as small if it has a total annual income of between $2 million and $10 million. There were 39,035 small enterprises in 2003-04.
A ‘medium’ enterprise is defined for the purposes of ATO classification as medium if it has a total annual income of between $10 million and $100 million. There were 10,009 medium enterprises in 2003-04.
than commercially realistic’ under the transfer pricing rules. A realistic profit under conditions of oligopoly would be expected to be much higher than profits under competitive market conditions. And, as competitive market conditions no longer exist in most international intercompany dealings, assessing a commercially realistic profit would be equally impossible. For example, with intercompany loans it might be possible to determine appropriate interest rates, other loan fees and contractual conditions on an arms length basis. The difficulty remains in determining whether or not the loan was commercially necessary.

Martin and Schumann observed that transfer pricing is “the simplest method”915 for shifting taxable profits from high taxing jurisdictions to low taxing jurisdictions. They conclude that

“State inspectors have no means of controlling this practice. Often it cannot be proved whether the prices in intra-firm trade are too high or not, because comparable prices scarcely exist for many of the items in question.”916

Although national taxing authorities, like Australia, try to respond to transfer pricing by instituting transfer pricing rules, reviews and audits in the end “the really good tax advisors are always a step ahead of the Revenue.”917 A tax lawyer with international clients promised that “in the end, any movements can be disguised through the complexity of the firm’s structure.”918 The ATO acknowledges the difficulty of assessing compliance with transfer pricing rules by setting a modest objective for its transfer pricing rules, that is, to be able to calculate the taxable income of a multinational ‘reasonably’.919 The ATO further acknowledges the difficulty of assessing compliance by stating that their approach to compliance “is to help large businesses to self regulate.”920

In 1982 Jerome Hellerstein921 remarked that “the Achilles heel of separate accounting is the inability to establish fair arm’s length prices for goods transferred, or basic operational services rendered, between controlled branches or subsidiaries of an enterprise.”922

916 Ibid, p199
917 Ibid, the authors are quoting Johannes Höfer a tax expert at the German economics ministry
918 Ibid
919 TR 97/20, para 1
920 Australian Taxation Office, 2006 Large Business and Tax Compliance,
Galbraith identified that ‘producers in the planning economy are able to control their prices because the other major firms in the market are complicit in the control of prices and the remaining firms, if any, are too small to impact on the market prices’. (Chapter 3)

Therefore, according to Galbraith’s theory of profits, corporate profits in the new industrial state are perfectly malleable as to quantum. And now, in the era of globalisation with virtually no controls over cross border flows of goods, services and currency, corporations can also determine in which tax jurisdiction profits will be made.

The following chapter will examine how much tax Australian companies actually pay.

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923 John Kenneth Galbraith, *Economics and the Public Purpose*, as above, Chapter XII
Chapter 7 How Much Tax Australian Companies Pay

Introduction

This chapter examines how much tax companies in Australia pay as:

- A comparison of company income tax revenues with the income tax revenues of other taxpayers. This comparison will assess the disproportion of the very few large company taxpayers, against the vast majority of taxpayers, that is, individual taxpayers.
- A percentage of their reported profits. Are companies, paying somewhere near the company tax rate - currently at 30% - of their profits as tax? Empirical work examines the annual returns of Australia’s largest public companies to determine whether or not there is a relationship between reported profits and reported tax paid. If there is a relationship, what is it and how does it compare to the rates of company tax payable prescribed by the legislation?

This chapter has been included in order to measure the concentration of corporate taxpayers in Australian and to measure the influence of corporate taxpayers on the total income tax base. This highlights the importance attached to correctly and fairly assessing corporations to taxation and in getting corporations to pay their fair share of taxation.

Australian Taxation Collections

The most recent taxation statistics produced by the Australian Taxation Office (ATO), and used in this chapter, are for the year 2004-05\(^\text{924}\) and were released in April 2007.

<table>
<thead>
<tr>
<th>Entity</th>
<th>2003-04 No.</th>
<th>2004-05 No.</th>
<th>%</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>10,978,900</td>
<td>11,235,993</td>
<td>85.4</td>
<td>85.3</td>
</tr>
<tr>
<td>Company</td>
<td>684,009</td>
<td>707,455</td>
<td>5.3</td>
<td>5.4</td>
</tr>
<tr>
<td>Partnership</td>
<td>447,207</td>
<td>434,491</td>
<td>3.5</td>
<td>3.3</td>
</tr>
<tr>
<td>Trust</td>
<td>501,860</td>
<td>533,268</td>
<td>3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>Fund</td>
<td>248,149</td>
<td>267,977</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Total</td>
<td>12,860,125</td>
<td>13,179,184</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


\(^\text{925}\) Ibid, p1
The majority of taxpayers are, unsurprisingly, individuals making up 85.3% of all taxpayers in Australia in 2004-05. In Australia, even though partnerships and trusts are required to lodge tax returns these entities do not pay tax. The taxable income of partnerships and trusts is distributed to either individuals or companies, who are liable to pay tax on the distribution.

Table 5

<table>
<thead>
<tr>
<th>Entity</th>
<th>Taxable Income</th>
<th>Net Tax</th>
<th>Net Tax/ Taxable Income</th>
<th>Net Tax/ Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual</td>
<td>423,742</td>
<td>103,608</td>
<td>24.4</td>
<td>69.6</td>
</tr>
<tr>
<td>Company</td>
<td>144,284</td>
<td>40,483</td>
<td>28.1</td>
<td>27.2</td>
</tr>
<tr>
<td>Fund</td>
<td>57,715</td>
<td>4,819</td>
<td>8.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Total</td>
<td>625,741</td>
<td>148,910</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Companies pay tax at an average rate of 28.1% of their taxable income, very close to the standard rate of Australian company tax of 30%. If Australian companies paid 30% tax on their taxable income tax collections for 2004-05 in Australia would have increased by $2,802 million to $43,285 million. In other words, tax concessions offered to Australian companies cost Australian revenue the amount of $2.8 billion.

Companies represent 5.4% of Australian taxpayers, by number of taxpayers, and contribute 27.2% of tax revenue. This disproportion, of the number of taxpayers to the amount of tax paid, is even greater when the tax paid by ‘large companies’ is considered.

Companies by Company Size

The ATO ranks companies by size based on their total income. The total income of a company is defined by the ATO as “the amount a company declared at item 6, label S of the 2005 company tax return.” Label S on the 2005 company tax return is the total income declared by a company and is made up as follows:

- Gross payments subject to foreign resident withholding

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926 Ibid, p3
927 Ibid, p3
928 Includes net business income distributions from partnerships and trusts
929 Large companies are defined by the ATO as companies with annual income in excess of $100 million.
929 Ibid, p27
930 Ibid
931 Ibid, p119 which consists of a copy of a company tax return form
- Gross payments where ABN\(^{932}\) not quoted
- Other sales of goods and services
- Gross distribution from partnerships
- Gross distribution from trusts
- Gross interest
- Gross rent and other leasing and hiring income
- Total dividends
- Fringe benefit employee contributions
- Assessable government industry payments
- Other gross income

Company size by total income per the ATO\(^{933}\) is:
- Loss/nil companies have a total income equal to or less than $0
- Micro companies have a total income equal to or more than $1 but less than $2 million
- Small companies have a total income equal to or more than $2 million but less than $10 million
- Medium companies have a total income between $10 million and $100 million (inclusive)
- Large companies have a total income of more than $100 million

**Table 6**

<table>
<thead>
<tr>
<th>Company Size</th>
<th>2003-04</th>
<th></th>
<th>2004-05</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>Loss/nil</td>
<td>89,325</td>
<td>13.1</td>
<td>91,189</td>
<td>12.9</td>
</tr>
<tr>
<td>Micro</td>
<td>544,152</td>
<td>79.6</td>
<td>562,910</td>
<td>79.6</td>
</tr>
<tr>
<td>Small</td>
<td>39,035</td>
<td>5.7</td>
<td>41,618</td>
<td>5.9</td>
</tr>
<tr>
<td>Medium</td>
<td>10,009</td>
<td>1.5</td>
<td>10,265</td>
<td>1.5</td>
</tr>
<tr>
<td>Large</td>
<td>1,488</td>
<td>0.2</td>
<td>1,473</td>
<td>0.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>684,009</strong></td>
<td><strong>100</strong></td>
<td><strong>707,455</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

\(^{932}\) ABN, Australian Business Number required by all Australian companies to be placed on sales invoices. Companies that are not registered for GST need not quote the ABN. The only Australian companies that need not be registered for GST are companies with an annual turnover of less than $50,000, that is, micro companies.

\(^{933}\) Ibid, p27

\(^{934}\) Ibid
Table 7

Company net tax by company size 2003-04 and 2004-05 income years

<table>
<thead>
<tr>
<th>Company Size</th>
<th>2003-04</th>
<th>2004-05</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>$m</td>
</tr>
<tr>
<td>Loss/nil</td>
<td>419</td>
<td>59</td>
</tr>
<tr>
<td>Micro</td>
<td>260,559</td>
<td>5,238</td>
</tr>
<tr>
<td>Small</td>
<td>27,790</td>
<td>3,830</td>
</tr>
<tr>
<td>Medium</td>
<td>7,306</td>
<td>5,062</td>
</tr>
<tr>
<td>Large</td>
<td>1,071</td>
<td>20,660</td>
</tr>
<tr>
<td>Total</td>
<td>297,145</td>
<td>34,850</td>
</tr>
</tbody>
</table>

The table above reveals that not all companies pay tax. The fact that nil/loss companies don’t pay taxes is unsurprising, what is surprising is the number of medium and large companies that don’t pay tax.

Table 8

Companies paying tax by company size 2004-05 income year

<table>
<thead>
<tr>
<th>Company Size</th>
<th>Total No. of Companies</th>
<th>No. Paying Tax</th>
<th>% Paying Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loss/nil</td>
<td>91,189</td>
<td>397</td>
<td>0.4</td>
</tr>
<tr>
<td>Micro</td>
<td>562,910</td>
<td>272,086</td>
<td>4.8</td>
</tr>
<tr>
<td>Small</td>
<td>41,618</td>
<td>29,254</td>
<td>70.3</td>
</tr>
<tr>
<td>Medium</td>
<td>10,265</td>
<td>7,698</td>
<td>75.0</td>
</tr>
<tr>
<td>Large</td>
<td>1,473</td>
<td>1,122</td>
<td>76.1</td>
</tr>
<tr>
<td>Total</td>
<td>707,455</td>
<td>310,827</td>
<td>43.9</td>
</tr>
</tbody>
</table>

The fact the loss/nil companies, that is, those companies with no income pay no tax is reasonably to be expected. However, the fact that over 95% of micro companies pay no tax is less expected. The surprise in the figures is that one quarter of companies, with an annual income of over $10 million, pays no income tax. The ATO offers no explanation of how it is that one quarter of substantial sized companies have no income tax payable.

The above table of ‘Taxable Income by Entity 2004-05 Income Year’ is restated below with the entity grouping of company divided into two classes of company - company and large company. This restatement highlights the impact that the 1,122 large taxpaying companies have on Australian income tax revenue.

---

935 Ibid, p33
Table 9

Taxable Income by Entity 2004-05 Income Year

<table>
<thead>
<tr>
<th>Entity</th>
<th>Net Tax $m</th>
<th>Net Tax/ Total %</th>
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<tr>
<td>Individual</td>
<td>103,608</td>
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<tr>
<td>Company</td>
<td>15,291</td>
<td>10.3</td>
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<tr>
<td>Large Company</td>
<td>25,192</td>
<td>16.9</td>
</tr>
<tr>
<td>Fund</td>
<td>4,819</td>
<td>3.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>148,910</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Large companies represent 0.01% of Australian taxpayers, by number of taxpayers and paid 16.9% of Australian income tax in the year 2004-05. Put another way, the average Australian taxpayer paid $11,299 in tax in the 2004-05 tax years. The average large company taxpayer paid $17,102,511 in tax in the 2004-05 tax years. That is, the large company taxpayer paid over 1,500 times the tax of an average taxpayer. The remainder of the chapter therefore concentrates on the largest of these large company taxpayers.

Selection of Australian Companies

Rationale

Companies selected for review are, of necessity, public companies because public companies must publish and make publicly available their annual returns. The selection of companies was based on size. Large companies have the most impact on tax collections because of the disproportionate amount of tax they contribute compared to the number of companies they represent.

Standard and Poors, a credit ratings agency, uses only market capitalisation to rank a company’s size as opposed to the ATO which uses total income. The 20 largest companies listed on the Australian Stock Exchange (ASX) represent 46% of the market capitalisation for Australia. Market capitalisation is simply a measure by which the market values a company, and is the sum of a company’s share price multiplied by the number of shares outstanding.

---

936 Ibid, p3
937 Includes net business income distributions from partnerships and trusts
938 The total number of Australian taxpayers in 2004-05 was 13,179,184 and of these taxpayers, 1,473 were classed as ‘large companies’ by the ATO
939 Total net tax receipts of $148,910 million, divided by 13.179 million taxpayers
940 Total net tax receipts from large companies of $25,192 million, divided by 1,473 taxpayers
issued to the market. This measure is not the same as the net worth of a company, nor is it a measure of the company’s turnover.

Forbes magazine, founded in 1917, is a bi-weekly business magazine published in New York City and is best known for producing rankings/lists in various categories of interest to the business community. One of these lists is a list of the world’s largest companies.

In contrast to Standard and Poors, Forbes “measures corporate size using four measures – sales, market value, assets and profits – to produce a composite measure of bigness.” Forbes’ rationale for using a composite of measures is that if trying “to determine the biggest companies with a single benchmark – say sales – and you wind up with a lopsided list, one cluttered with retailers, in that case.”

In March 2007 Forbes published its list of the World’s largest 2000 companies in 2006. Included in this list were forty three Australian companies. These companies were selected for the review of Australian companies and how much tax they actually pay.

### Table 10

**Australia’s Largest Public Companies**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
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<td>90</td>
<td>National Australia Bank</td>
<td>Banking</td>
<td>28.20</td>
<td>3.28</td>
<td>360.56</td>
<td>51.79</td>
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<td>128</td>
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<td>Banking</td>
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<td>2.92</td>
<td>273.74</td>
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<td>Banking</td>
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<td>2.75</td>
<td>249.54</td>
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<td>2.29</td>
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<td>6.18</td>
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<td>30.42</td>
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<tr>
<td>406</td>
<td>AMP</td>
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<td>0.74</td>
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<td>15.23</td>
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<td>QBE Insurance Group</td>
<td>Insurance</td>
<td>7.02</td>
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<td>20.64</td>
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<td>0.75</td>
<td>9.67</td>
<td>25.80</td>
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<td>St George Bank</td>
<td>Banking</td>
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<td>0.80</td>
<td>79.71</td>
<td>13.81</td>
</tr>
<tr>
<td>532</td>
<td>Macquarie Bank</td>
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<td>0.68</td>
<td>75.86</td>
<td>15.79</td>
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<td>Food Markets</td>
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<td>0.89</td>
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<td>14.46</td>
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<td>0.68</td>
<td>42.62</td>
<td>9.70</td>
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<tr>
<td>775</td>
<td>Brambles</td>
<td>Business Services and Supplies</td>
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<td>1.45</td>
<td>6.58</td>
<td>32.23</td>
</tr>
<tr>
<td>789</td>
<td>Qantas Airways</td>
<td>Transportation</td>
<td>10.06</td>
<td>0.36</td>
<td>14.25</td>
<td>8.05</td>
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<tr>
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<td>Insurance</td>
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<td>0.56</td>
<td>12.49</td>
<td>8.27</td>
</tr>
<tr>
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<td>Wesfarmers</td>
<td>Conglomerates</td>
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<td>0.78</td>
<td>5.52</td>
<td>10.89</td>
</tr>
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<td>Woodside Petroleum</td>
<td>Oil &amp; Gas Operations</td>
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<td>1.12</td>
<td>6.92</td>
<td>19.31</td>
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<td>Fosters Group</td>
<td>Food Drink &amp; Tobacco</td>
<td>3.65</td>
<td>0.87</td>
<td>7.44</td>
<td>10.10</td>
</tr>
<tr>
<td>985</td>
<td>Rinker Group</td>
<td>Construction</td>
<td>4.89</td>
<td>0.71</td>
<td>4.46</td>
<td>13.25</td>
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<td>1029</td>
<td>GPT Group</td>
<td>Diversified Financials</td>
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<td>1.07</td>
<td>9.45</td>
<td>8.12</td>
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<td>Stockland</td>
<td>Diversified Financials</td>
<td>0.75</td>
<td>0.79</td>
<td>7.13</td>
<td>9.44</td>
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<tr>
<td>1113</td>
<td>Lend Lease</td>
<td>Diversified Financials</td>
<td>9.01</td>
<td>0.31</td>
<td>5.77</td>
<td>5.69</td>
</tr>
<tr>
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<td>Amcor</td>
<td>Materials</td>
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<td>0.26</td>
<td>7.25</td>
<td>5.20</td>
</tr>
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<td>Media</td>
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<td>10.30</td>
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<td>Transportation</td>
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<td>9.65</td>
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<td>Origin Energy</td>
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<td>Bluescope Steel</td>
<td>Materials</td>
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<td>5.30</td>
<td>5.34</td>
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<td>Zinifex</td>
<td>Materials</td>
<td>2.28</td>
<td>0.80</td>
<td>2.03</td>
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<td>Orica</td>
<td>Chemicals</td>
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<td>5.40</td>
</tr>
</tbody>
</table>

---

The following table records how much tax, as a percentage of reported profits, these large Australian companies paid in 2005 and 2006.

As at March 2007 there were forty three Australian companies in the Forbes list of the world’s largest 2,000 companies. The Annual Returns of these 43 companies was obtained and, for the financial reporting years 2005 and 2006, the reported net profit before tax (‘NPBT’) was compared to the income tax expense (‘ITE’) of the company. A sub-total of the twenty largest companies (of the forty three) was taken to gauge the concentration of size of Australia’s largest companies.
<table>
<thead>
<tr>
<th>Company</th>
<th>NPBT 2006 $m</th>
<th>ITE 2006 $m</th>
<th>%</th>
<th>NPBT 2005 $m</th>
<th>ITE 2005 $m</th>
<th>%</th>
</tr>
</thead>
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<tr>
<td>1 National Australia Bank</td>
<td>7275</td>
<td>2134</td>
<td>29%</td>
<td>6416</td>
<td>1814</td>
<td>28%</td>
</tr>
<tr>
<td>2 BHP Billiton</td>
<td>19048</td>
<td>4889</td>
<td>26%</td>
<td>11615</td>
<td>3004</td>
<td>26%</td>
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<tr>
<td>3 Commonwealth Bank</td>
<td>5859</td>
<td>1569</td>
<td>27%</td>
<td>5012</td>
<td>1374</td>
<td>27%</td>
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<td>4 ANZ Banking</td>
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<td>5 Westpac Banking group</td>
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<td>31%</td>
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<td>1223</td>
<td>29%</td>
</tr>
<tr>
<td>6 Telstra</td>
<td>4561</td>
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<td>6055</td>
<td>1746</td>
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<td>430</td>
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<td>386</td>
<td>28%</td>
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<tr>
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<td>2578</td>
<td>608</td>
<td>24%</td>
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<td>35%</td>
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<td>33%</td>
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<td>0%</td>
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<td>293</td>
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<td>28%</td>
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<td>333</td>
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<td>18%</td>
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<tr>
<td>35 Allinta</td>
<td>168</td>
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<td>45</td>
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<tr>
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<td>701</td>
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<td>430</td>
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<td>26%</td>
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<td>265</td>
<td>20</td>
<td>8%</td>
</tr>
<tr>
<td>43 Metcash</td>
<td>133</td>
<td>52</td>
<td>39%</td>
<td>185</td>
<td>58</td>
<td>31%</td>
</tr>
<tr>
<td><strong>ST of cos 21-43</strong></td>
<td>12538</td>
<td>2238</td>
<td>18%</td>
<td>11052</td>
<td>2612</td>
<td>24%</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>84,393</strong></td>
<td><strong>20,069</strong></td>
<td><strong>24%</strong></td>
<td><strong>68,848</strong></td>
<td><strong>17,496</strong></td>
<td><strong>25%</strong></td>
</tr>
</tbody>
</table>

* Publicly listed trust companies
The average taxation expense of the twenty largest companies was 25% of reported net profits in 2005 and 26% in 2006. The average taxation expense of the following twenty companies, ranked by size was 18% of reported net profits in 2005 and 24% in 2006. Matters to note from these figures are:

1. The income tax expense of the twenty largest companies remained at a fairly constant percentage to profits for the two years as opposed to the tax expense of the next twenty three companies,

2. The income tax expense, in dollar terms was disproportionately concentrated in the twenty largest companies. In 2005 these companies had an income tax expense of $17.8 billion compared with $2.2 billion for the next ranked in size, that is, eight times the income tax expense. In 2006 these companies had an income tax expense of $14.9 billion compared with $2.6 billion for the next ranked in size, that is, six times the income tax expense and,

3. The ATO reported that in 2004-05 large companies paid $25.2 billion in tax and that this was paid by 1,122 companies. The above figures show that Australia’s 43 largest companies had an income tax expense of $20 billion. Even though the tax years and the financial years may not be the same, these figures show that approximately, 3.8% of large company taxpayers are paying 79.4% of large company tax.

This demonstrable concentration of economic strength in a very few corporations provides further support for Galbraith’s market theory which recognised that the modern market economy was divided between the major corporations which wield power over the market and the remaining economic actors which wield no power.\textsuperscript{945}

**Tax Treatment of Publicly Listed Trusts**

Australia’s forty three largest companies include four publicly listed corporations that manage property trusts. These companies pay substantially less tax than ordinary corporations because of Australian tax law which makes the beneficiaries of trusts liable to taxation on income distributed by a trust. The property trusts included above are:

- Westfield Group
- GPT Group
- Stockland
- Mirvac Group

Under Australian taxation law a trust is an ‘obligation’ binding a person, the trustee, to deal with property in his control for the benefit of persons or objects. Trustee has legal ownership

of property which he holds for the benefit of beneficiaries or charitable objects to which he has a fiduciary duty. A trustee is not generally liable to pay income tax. The *Income Tax Assessment Act* (‘ITAA’) provides that “Except as provided in this Act, a trustee shall not be liable as trustee to pay income tax upon the income of the trust estate.”

In Australia, persons entitled to trust income must include that income in their assessable income. However, the ITAA imposes the tax liability on the trustee where the beneficiary is presently entitled but under a legal disability. The trustee is assessed as if it were the income of an individual and not subject to any deduction. Beneficiaries under a legal disability are minors or infants (those under 18 years of age), a bankrupt or someone without legal capacity due to say, insanity or, illness such as Alzheimer’s or, incapacity due to coma.

In the circumstances of listed property trusts the beneficiaries, also called securityholders, are all considered to be presently entitled to the income of the trust and not under any legal disability. This is because securityholders are held not be under a legal disability, even if they hold the securities for a person under a legal disability.

Public trading trusts, trusts where the units are listed on the stock exchange or otherwise offered for sale to the public, are “treated as if they are companies for tax purposes. The trust is taxed at the company rate of tax and distributions to equity holders are assessable on the same basis as dividends.” The reason that the above corporations, property trust companies, pay substantially less tax than most of the publicly listed corporations examined above is that the entities making up the ‘trust’ companies consist of taxable and non-taxable entities. The non-taxable entities are the trusts that are managed by the taxable entity, the listed company. The trusts are not subject to tax, however any income earned by the taxable entity, that is, the listed holding company, is subject to tax at normal company rates of tax.

Table 12, showing the tax paid by the 43 largest companies, has been adjusted for companies that manage trusts and, so distort the rate of company tax paid by the remaining corporations.

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947 ITAA36, s96
948 ITAA36, s97
949 ITAA36, s98
950 Mendel J (Ed), *Australian Master Tax Guide*, as above, p247
951 Westfield Group, *Annual Report 2006*, note 2, ‘summary of significant accounting policies – taxation’, p37, this tax note is typical of the situation of all listed property trust companies
Table 12

Summary Financial Position of Australia’s Largest Companies

<table>
<thead>
<tr>
<th>Company</th>
<th>NPBT</th>
<th>ITE</th>
<th>%</th>
<th>NPBT</th>
<th>ITE</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$m</td>
<td>$m</td>
<td>%</td>
<td>$m</td>
<td>$m</td>
<td>%</td>
</tr>
<tr>
<td>TOTAL of 43</td>
<td>84,393</td>
<td>20,069</td>
<td>24</td>
<td>68,848</td>
<td>17,496</td>
<td>25</td>
</tr>
<tr>
<td>Subtract Trust Coys</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7 Westfield Group</td>
<td>6,196</td>
<td>560</td>
<td>9</td>
<td>4,741</td>
<td>472</td>
<td>10</td>
</tr>
<tr>
<td>22 GPT Group</td>
<td>1,385</td>
<td>1</td>
<td>0</td>
<td>566</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>23 Stockland</td>
<td>1,267</td>
<td>61</td>
<td>5</td>
<td>817</td>
<td>52</td>
<td>6</td>
</tr>
<tr>
<td>42 Mirvac Group</td>
<td>488</td>
<td>45</td>
<td>9</td>
<td>265</td>
<td>20</td>
<td>8</td>
</tr>
<tr>
<td>Trust Total</td>
<td>9,336</td>
<td>667</td>
<td>7</td>
<td>6,389</td>
<td>544</td>
<td>9</td>
</tr>
<tr>
<td>Total Excluding Trusts</td>
<td>75,057</td>
<td>19,402</td>
<td>26</td>
<td>62,459</td>
<td>16,952</td>
<td>27</td>
</tr>
</tbody>
</table>

Additional Company Information

All Australian companies must include in their annual reports a note to the financial statements reconciling the actual income tax expense of the company with the prima facie tax expense of 30% of reported profits. As we see below, this reconciliation does not necessarily clarify why a corporation is paying less or more than the statutory rate of tax on their reported profits.

1. National Australia Bank Limited


Major activity – banking

Basis of preparing accounts – Australian equivalents to International Financial Reporting Standards (‘AIFRS’)

Tax Commentary – The effective rate of tax in 2006 was 29.3% compared to 28.3% in the previous year. NAB explains that when statutory funds attributable to the life insurance business, to which a wide range of tax rates are applied, the effective rate rises to 29.9% consistent with the prima facie tax rate of 30%. The effective rate for 2005 was only 24.6%. This “was favourably impacted by the non-assessable profit in respect of the sale of the Irish Banks amounting to $372 million, partly offset by the settlement of the ATO tax dispute of $97 million.”952 There were no details given about the ATO dispute, merely that is had been settled in favour of the ATO.

2. BHP Billiton Limited

Major activity – global resources, petroleum, aluminium, base metals, carbon steel materials, diamonds, coal and stainless steel

Basis of preparing accounts – International Financial Reporting Standards (‘IFRS’) as adopted by the European Union in $US.

Tax Commentary – The effective rate of tax in 2006 and 2005 remained constant at 25.6%. In 2006 the tax expense differed from the standard rate of corporation tax of 30% due to three major items;

1. Investment and development allowance of $US219 million,
2. Recognition of prior year tax losses $US429 million and
3. Adjustments to income tax expense relating to jointly controlled enterprises $US668 million.953

These three items were also responsible for the majority of the difference between the standard rate of corporate tax and actual tax expense for the 2005 income year.

Note – BHP Billiton’s annual reports are expressed in $US. These US amounts were converted at the $US to $Aus exchange rate as at June 2006 and 2005 respectively.954

3. Commonwealth Bank Limited

Major activity – banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 26.8% compared to 27.4% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate

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954 Australian Government, *Foreign Exchange Rates*, [http://www.ato.gov.au/print.asp?doc=/content/22855.htm](http://www.ato.gov.au/print.asp?doc=/content/22855.htm), accessed 25 June, 2007. The official ATO exchange rates were used. As at June 2006 this was 0.7437 and as at June 2005 this was 0.7697.
of corporate tax of 30% was a decrease in tax due to a “tax adjustment referable to policyholder income of $232 million.”

4. ANZ Limited

Major activity – banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 29.2% compared to 27.7% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to profit from associated and joint venture entities of $57 million not being subject to tax.

5. Westpac Banking Group Limited

Major activity – banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 31.3% compared to 29.3% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to non-assessable items of $138 million and an increase in tax due to non-deductible items of $120 million.

6. Telstra Corporation Limited

Major activity – Telecommunications services

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955 Commonwealth Bank of Australia, Annual Report 2006, Note 5, p123
956 ANZ, Financial Report 2006, note 6, p19
957 Westpac, 2006 Annual Financial Report, note 6, p101
Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 30.3% compared to 28.8% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was due to “deferred tax resulting from the origination and reversal of temporary differences”\(^958\) of $386 million.

7. Westfield Group Limited

Major activity – property trust and global shopping centre group

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 9.0% compared to 10.0% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to non-assessable income for the Westfield Trust of $1,243 million and differential rates of tax on US foreign income of $218 million\(^959\).

8. AMP Limited

Major activity – financial services, superannuation provider

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 46.9% compared to 49.1% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was due to the fact the “income tax expense amount reflects the impact of both income tax attributable to shareholders as well as income tax attributable to policyholders”\(^960\). In 2006 this amounted to $531 million and in 2005 it amounted to $504 million.\(^961\) The income tax expense

\(^958\) Telstra Corporation Limited and Controlled Entities, *Financial Report as at 30 June 2006*, note 9, p43
\(^959\) Westfield Group, *Annual Report 2006*, note 9, p40
\(^961\) Ibid
attributable to shareholders was therefore $278 million in 2006 and $257 million in 2005.\textsuperscript{962} The effective rate of tax attributable to shareholders was, therefore, 23.3% in 2006 and 24.5% in 2005.\textsuperscript{963}

9. QBE Insurance Group Limited
Information source – Annual Report 2006, for the year ended 31 December 2006

Major activity – insurance

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was negative 1% compared to 2.6% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was due to the fact of untaxed dividends of $687 million.\textsuperscript{964} QBE explains the tax situation of the group thus: “The company is the head entity in a tax-consolidated group comprising the company and the Australian entities. All entities in the tax-consolidated group continue to account for their own current and deferred tax amounts. These tax amounts are measured as if each entity continues to be a stand-alone tax payer in its own right. In addition to its own current and deferred tax amounts\textsuperscript{965} the company also recognises any current tax or deferred tax arising from unused tax losses and unused tax credits assumed from controlled entities in the tax consolidated group.”

The notes to the accounts do not allow the reader to determine how much tax was paid by the subsidiary companies and allowed to the holding company via dividend imputation. However, when examining the details of franking credits available to the shareholders of the QBE Group, it reveals that QBE Group shareholders were entitled to a franking credit of 60% (55% in 2005)\textsuperscript{966} which means that the subsidiaries of QBE must have paid taxes of approximately 60% of the prima facie tax rate of 30%, that is, at around 18% of reported profits (16.5% in 2005).

10. Woolworths Limited
Information source – Annual Report 2006, for the 52 weeks ended 25 June 2006

\textsuperscript{962} Ibid
\textsuperscript{963} Ibid, calculated as follows; 2006 tax attributable to shareholders $278m divided by profit before income tax excluding tax charged to policyholders $1,193m: 2005 tax attributable to shareholders $257m divided by profit before income tax excluding tax charged to policyholders $1,047m.
\textsuperscript{964} QBE Insurance Group, Annual Report 2006, note 8, p91
\textsuperscript{965} Ibid, note 1(J), p76.
\textsuperscript{966} Ibid, note 25E, p112
Major activity – supermarkets

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 30.3% compared to 29.9% in the previous year. In 2006 the items causing the tax expense to differ from the standard rate of corporate tax of 30% were all minor, that is, less than $6 million.  

11. St. George Bank Limited

Major activity – banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 29.5% compared to 30.7% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were an increase in tax due to preference share dividends classified as interest expense of $11 million and a decrease in tax due to the difference between accounting profit and assessable profit on the sale of buildings of $25 million.  

12. Macquarie Bank Limited

Major activity – diversified financials

Basis of preparing accounts – Australian Accounting Standards

Tax Commentary – The effective rate of tax in 2007 was 19.6% compared to 22.5% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to tax rate differential in off-shore income of $195 million.  

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13. Coles Myer Limited

Major activity – retailing

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 28.7% compared to 29.4% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in the tax due to a non-taxable gain on the disposal of controlled entities and businesses of $192.7 million\(^{970}\).

14. Suncorp-Metway Limited

Major activity – financial services

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 31.9% compared to 28.0% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to statutory funds of $36 million.\(^{971}\) Statutory funds, required to be held, in the life insurance business of the company, are subject to differing tax rates, which accounts for the difference in the income tax expense from the normal company rate of 30%.\(^{972}\)

15. Brambles Limited

Major activity – business and service supplies

Basis of preparing accounts – AIFRS in $US\(^{973}\)

\(^{971}\) Suncorp-Metway Limited, *Annual Report 2006*, note 9, p86
\(^{972}\) Ibid, p87
\(^{973}\) Brambles reports in $US which, for this exercise, were converted at the official ATO exchange rates per Note 13. As at June 2006 this was 0.7437 and as at June 2005 this was 0.7697.
**Reconciliation of profit before tax and the income tax expense:**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit before tax</td>
<td>589.3</td>
<td>475.9</td>
</tr>
<tr>
<td>Profit from discontinued operations before tax</td>
<td>1,327.6</td>
<td>216.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,916.9</td>
<td>691.9</td>
</tr>
</tbody>
</table>

Less:  
- Tax attributable to continuing operations | 226.7  | 162.8  |
- Tax attributable to discontinued operations | 225.8  | 80.3   |

**Profit after tax** | 1,464.4 | 448.8 |

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating profit before tax</td>
<td>792.4</td>
<td>618.3</td>
</tr>
<tr>
<td>Profit from discontinued operations before tax</td>
<td>1,785.1</td>
<td>280.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,577.5</td>
<td>898.9</td>
</tr>
</tbody>
</table>

Less:  
- Tax attributable to continuing operations | 304.8  | 211.5  |
- Tax attributable to discontinued operations | 303.6  | 104.3  |

**Profit after tax** | 1,969.1 | 583.1 |

**Tax Commentary** – The effective rate of tax in 2006 was 23.6% compared to 35.1% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to the tax benefits achieved by Brambles from the completion of the sale of all of Brambles’ non-core businesses in 2006.  

16. Qantas Airways Limited  
Information source – *Annual Report 2006* and for the year ended 30 June 2006  

Major activity – airline  

Basis of preparing accounts – AIFRS  

**Tax Commentary** – The effective rate of tax in 2006 was 28.5% compared to 24.6% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to non-deductible expenditure of

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$12.1 million and a decrease in tax due to a tax offset for franked dividends received of $8.9 million and the utilisation of previously unrecognised losses of $14.5 million.\textsuperscript{975}

17. IAG Insurance Australia Group Limited

Major activity – insurance

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 30.2% compared to 27.8% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to non-deductible items of $13 million and a decrease in tax due to the receipt of rebateable dividends of $19 million.\textsuperscript{976}

18. Wesfarmers Limited

Major activity – diversified conglomerate

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 28.6% compared to 27.4% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to non-deductible items of $18.6 million and a decrease in tax due to carried forward tax losses now recognised of $18.8 million and tax on undistributed associates profit of $20.7 million.\textsuperscript{977}

19. Woodside Petroleum Limited

Major activity – resources

\textsuperscript{975} Qantas Airways Limited, *Annual Report 2006*, note 4, p83
\textsuperscript{976} IAG Insurance Australia Group Limited, *Annual Report 2006*, note 6, p76
\textsuperscript{977} Wesfarmers Limited, *Annual Report 2006*, note 5, p75
Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 29.0% compared to 25.8% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to foreign exploration tax losses not brought to account of $54.1 million and a decrease in tax due to foreign tax assets brought to account of $49.9 million.978

20. Foster’s Group Limited
Information source – Annual Report 2006 for the year ended 30 June 2006

Major activity – drinks company: beer and wine

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 2.4% compared to 1.1% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to non-taxable income and profits of $83.4 million and the utilisation of losses of $119.6 million.979 Foster’s reported that in addition to the losses utilised in the 2006 financial year there are “potential future income tax benefits relating to accumulated losses in Australia and overseas which have not been brought to account. These possible benefits amount to $322 million (2005: $271.9 million)980.

Foster’s Group utilised losses in 2006 amounting to $119.6 million and yet the accumulated losses available to the Group rose from $271.9 million to $322 million. “These losses are associated with the funding of Elders Finance Group in the 1980s and 1990s”981 Elders Finance was associated with Foster’s at the time through John Elliot who was a director of both companies. In June 2007 the ATO issued Foster’s with an income tax assessment in respect of some of these tax losses claimed by Foster’s. The ATO issued assessments “for total primary tax of $548.7 million and penalties and interest of $302 million… Foster’s view is that its maximum exposure in relation to these and related assessments is limited to

979 Foster’s Group Limited, Annual Report 2006, note 5, p59
980 Ibid, p60
$340.9 million for primary tax and $204.8 million for penalties and interest.”

Foster’s has objected to the assessments of the ATO but no decision had been finalised at the date of writing.

21. Rinker Group Limited

Major activity – construction materials

Basis of preparing accounts – AIFRS in $US

Tax Commentary – The effective rate of tax in 2006 was 33.9% compared to 33.0% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to overseas tax rate differential of $US64.8 million.

22. The GPT Group
Information source – Annual Report 2006 for the year ended 31 December 2006

Major activity – property trust

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 0.1% compared to 0.0% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to profit attributed to entities not subject to tax of $1,363 million. GPT is not a limited liability company it operates as a trust for its security holders. Under current Australian taxation legislation “Trusts are not liable for income tax, provided their taxable income and taxable realised gains are fully distributed to Securityholders each financial year.” Under Australian taxation legislation the security holders are liable to pay tax on their distribution of income from the trust.

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982 Ibid
983 That is, at 19 February, 2008
985 The GPT Group, Annual Report 2006, note 6, p102
986 Ibid, note 1s, p92
23. Stockland Corporation Limited
Information source – Annual Report 2006 for the year ended 30 June 2006

Major activity – property trust

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 4.8% compared to 6.4% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to profit attributed to entities not subject to tax of $1,363.6 million. Stockland Corporation Limited administers the Stockland Group, which is not a limited liability company, but is a trust for its security holders. Under current Australian taxation legislation trusts are not liable for income tax, provided their taxable income and taxable realised gains are fully distributed to the beneficiaries each financial year.

24. Lend Lease Corporation Limited

Major activity – property owner and developer

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 26.2% compared to 32.5% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to a recovery of tax losses of $20.8 million and an increase in tax due to a variation in tax rates of $20.9 million.

25. Amcor Limited

Major activity – timber and paper

Basis of preparing accounts – AIFRS

987 The Stockland Corporation Limited, Annual Report 2006, note 8, p82
988 Lend Lease Corporation Limited, Annual Consolidated Financial Report 2006, note 6a., p70
Tax Commentary – The effective rate of tax in 2006 was 14.1% compared to 20.6% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to capital structures of $60.3 million.\footnote{Amcor Limited, Financial Report 2006, note 9, p29}

26. PBL Publishing and Broadcasting Limited

Major activity – gaming and media

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 17.8% compared to 14.1% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to an over provision of tax from prior years of $61.7 million.

27. Toll Holdings Limited

Major activity – freight forwarding

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 19.3% compared to 22.0% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to:

- Tax deductible expenditure and depreciation not included in operating profit $15m
- Non-assessable gains $4m
- Utilisation of tax losses not previously recognised $21m
- Share of associates net profit $10m

There was also an increase in the tax expense due to:

- Non Deductible expenditure $19m\footnote{Toll Holdings Limited, Annual Financial Report 2006, note 7, p91}
28. Origin Energy Limited

Major activity – oil and gas exploration, electricity generation and sale and utility infrastructure

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 27.1% compared to 26.9% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were an increase in tax due to differences between Australian and overseas tax rates of $10.0 million and decreases in tax due to share of net profit of associates of $9.8 million and recognition of change in net tax loss position of $12.5 million.991

29. Bluescope Steel Limited

Major activity – flat steel products

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 26.9% compared to 25.4% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to the recognition and utilisation of unbooked tax losses of $44.5 million.992

30. Zinifex Limited

Major activity – zinc mining

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was a benefit of 14.2% compared to a benefit of 14.2% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to tax assets recouped during the period of $262.6 million and recognition of additional tax losses not previously recognised as deferred tax assets of $156.5 million\textsuperscript{993}.

31. Orica Limited

Major activity – fertilisers and chemicals

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 27.5% compared to 28.0% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to other foreign deductions of $25.1 million.\textsuperscript{994}

32. Tabcorp Holdings Limited

Major activity – gaming and media

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 21.9% compared to 31.6% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were:

- A decrease in tax due to the “recognition of tax benefit upon entry into tax consolidation and resetting tax values”\textsuperscript{995} of $70.7 million. In September 2004 Tab Limited obtained full beneficial ownership of Tabcorp Holdings Limited. “An income tax benefit is recognised in the current year resulting from the finalisation of resetting tax values of certain assets.”\textsuperscript{996}

\textsuperscript{993} Zinifex Limited, Annual Report 2006, note 8, p66
\textsuperscript{994} Orica Limited, Annual Report 2006, note 5
\textsuperscript{995} Tabcorp Holdings Limited, Financial Report 2006, Note 4, p 14
\textsuperscript{996} Ibid, p16
• An increase in tax due to “impairment of goodwill” of $17.9 million.

33. Santos Limited
Information source – *Annual Report 2006 for the year ended 31 December 2006*

Major activity – petroleum and natural gas

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 32.4% compared to 32.7% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to foreign losses not recognised of $41.3 million.  

34. Babcock & Brown Limited
Information source – *Annual Report 2006 for the year ended 31 December 2006*

Major activity – global investment and advisory

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 14.4% compared to 18.0% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to equity accounted profits of $32.1 million and difference in overseas tax rates of $45.2 million.

35. Alinta
Information source – *Annual Financial Report 2006 for the year ended 31 December 2006*

Major activity – energy and infrastructure

Basis of preparing accounts – AIFRS

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997 Ibid, p14
998 Santos Limited, *Annual Report 2006*, note 6, p87
Tax Commentary – The effective rate of tax in 2006 was a benefit of 1.2% compared to an expense of 37.7% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to:

- Restatement of deferred tax balances $18.0 million
- Rebatable dividends $23.1 million
- Share of profits of associates $4.2 million
- Project costs $11.1 million
- Overprovision of tax in prior years $11.5 million

There was also an increase in the tax expense due to:

- Capital gain on sale of asset $15.4 million

The tax expense in 2005 was greater than the standard rate because of increases in tax due to:

- Unfranked dividends $8.2 million
- Share of profits of associates $2.2 million
- Interest – reset preference shares $2.3 million
- Project costs $3.4 million

There was also a decrease in the tax expense due to:

- Overprovision of tax in prior years $3.7 million

This dramatic difference in the tax expense between 2006 and 2005 is unusual.

36. Adelaide Bank Limited
Information source – Annual Report 2006 for the year ended 30 June 2006

Major activity – banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 31.9% compared to 30.8% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to non-deductible expenses of $5.3 million.

---

1001 Adelaide Bank Limited, Annual Report 2006, note 4, p49
37. Challenger Financial Services Group Limited

Major activity – investment banking

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 28.2% compared to 27.2% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were an increase in tax due to expenditure not allowable for income tax purposes of $8.9 million and a decrease in tax due to the recoupment of previously unrecognised tax losses of $5.5 million.\(^{1002}\)

38. CSL Limited

Major activity – biopharmaceuticals

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 31.2% compared to 30.4% in the previous year. The major items causing the tax expense to differ from the standard rate of corporate tax of 30% were increases/(decreases) in tax due to:

<table>
<thead>
<tr>
<th></th>
<th>2006(^{1003})</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Research and development</td>
<td>(3.0)</td>
<td>(2.4)</td>
</tr>
<tr>
<td>Non-assessable capital loss/(gain)</td>
<td>2.1</td>
<td>51.2</td>
</tr>
<tr>
<td>Other non-deductible expenses</td>
<td>7.6</td>
<td>9.9</td>
</tr>
<tr>
<td>(Utilisation of tax losses)/Unrecognised deferred tax assets</td>
<td>(13.2)</td>
<td>22.2</td>
</tr>
<tr>
<td>Effects of different rates of tax on overseas income</td>
<td>5.8</td>
<td>16.3</td>
</tr>
<tr>
<td>Under provision in prior year</td>
<td>2.7</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Even though this company had an income tax expense in 2006 and 2005 that was close to the standard rate of corporate income tax there were large tax reconciling items in each of the years that are evidence of some major corporate restructuring.

---

39. Coca-Cola Amatil Limited
Information source – Annual Report 2006 for the year ended 31 December 2006

Major activity – food and beverages

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 28.8% compared to 25.6% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to overseas withholding tax of $9.1 million.1004

40. Newcrest Mining Limited
Information source – Concise Annual Report 2006 and Supplementary Information Booklet 2006 for the year ended 30 June 2006

Major activity – gold and copper mining

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 25.5% compared to 30.8% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to the “recognition of capital cost base and capital tax losses not previously brought to account in relation to disposal of discontinued operation”1005 of $62.5 million.

41. Boral Limited

Major activity – building and construction materials

Basis of preparing accounts – AIFRS

1004 Coca-Cola Amatil Limited, Annual Report 2006, note 6, p77
1005 Newcrest Mining Limited, Supplementary Information Booklet Year Ended 30 June 2006, note 4, p56
Tax Commentary – The effective rate of tax in 2006 was 29.7% compared to 30.5% in the previous year. In 2006 the major items causing the tax expense to differ from the standard rate of corporate tax of 30% were a decrease in tax due to the share of associate’s net profit and franked dividend of $14.4 million and an increase in tax due to difference between Australian and overseas tax rates of $15.2 million.  

42. Mirvac Group  

Major activity – property trust

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 9.2% compared to 7.5% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was a decrease in tax due to trust net income of $103.2 million.

43. Metcash Limited  
Information source – Annual Report 2006 for the year ended 30 April 2006

Major activity – retailer

Basis of preparing accounts – AIFRS

Tax Commentary – The effective rate of tax in 2006 was 39.1% compared to 31.3% in the previous year. In 2006 the major item causing the tax expense to differ from the standard rate of corporate tax of 30% was an increase in tax due to expenditure not allowable for income tax purposes of $11.9 million. In 2005, this item was also the main reason for the income tax expense being greater than the standard rate of corporate tax, however in 2005 the amount was $2.7 million. NPBT was $133m in 2006, therefore the non-deductible expenses were just under 10% of the profit – substantial but no explanation.

1007 Mirvac Group, Annual Financial Report 2006, note 6, p68  
1008 Metcash Limited, Annual Report 2006, note 5, p53
Summary of Company Tax Receipts

In Australia “Company income tax has grown from $18 billion in 1993-94 to $40 billion in 2004-05, outstripping the growth in gross domestic product (GDP).” During this period company tax rates have actually fallen as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995-00</td>
<td>36%</td>
</tr>
<tr>
<td>2000-01</td>
<td>34%</td>
</tr>
<tr>
<td>2001-07</td>
<td>30%</td>
</tr>
</tbody>
</table>

In the six years from 2001-02 to 2006-07, when company tax rates were stable at 30% of taxable profits, company tax collections have grown a further 109%.

The ATO proffers no explanation of this increase in company tax receipts. The tax receipts could have increased due to a number of factors or combination of factors, including:

- More business being undertaken in the corporate form as opposed to sole trader or partnerships. As noted above, in the two years from 2003-04 to 2004-05 the number of company taxpayers increased from 684,007 to 707,455. In the same period however, the number of large companies (companies with an annual income of over $100 million) actually decreased from 1,488 to 1,473.
- Increased tax compliance by companies leading to an increase in the amount of tax collections
- Increased profitability of companies at the expense of the profitability of other forms of enterprise.

The ATO has reported that “large businesses represented 62% ($25 billion) of income tax collections from companies in 2004-05. In 2005-06, this share grew to around two thirds of company tax collections.” In other words, even though the trend is for slightly fewer large company taxpayers, their share of tax paid has actually increased. This concentration of the large company is highlighted by the following contributions to revenue, in addition to income tax, from large companies in 2004-05:

- 59% ($19 billion) of total net GST

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1010 Twomey A and Withers G, Federalist Paper 1 Australia’s Federal Future, a report for the Council for the Australian Federation, Australia, April 2007, p36

1011 Australian Taxation Office, 2006 Large Business and Tax Compliance, as above, p3

1012 Ibid
• 99% ($22 billion) of excise revenue
• 100% ($1.5 billion) of petroleum resource rent tax
• 56% ($2 billion) of fringe benefits tax, and
• 66% ($3 billion) of superannuation funds income tax.

GST is not actually paid by companies in Australia, they collect GST for the ATO from the end-users of their products and services, that is, usually, the retail consumer.

In Australia, excise tax is charged on petroleum products, tobacco and alcohol products.

The above statistics demonstrate the existence of Galbraith’s *New Industrial State* in modern Australia. From the above statistics the concentration of employment, and sales of goods and services in Australia appears to be approximately two thirds in the control of large companies, that is in the control of a mere 1,473 enterprises.

**Conclusion**

A very small number of companies in Australia make disproportionately significant contributions to taxation revenue. Examination of the forty three largest company tax payments, above, has revealed that in 2006 they paid 26% tax on their reported income before tax (27% in 2005). Compared to the company tax rate of 30% major Australian corporations appear to be paying close to the legislated company tax rate. However, company taxes are paid on reported profits and, as was seen in the previous chapter, there is no way of knowing how those profits have been manipulated.

Australia’s 43 largest companies paid $20.1 billion in taxation in 2006 and $17.5 billion in 2005. In 2005 total company tax receipts in Australia were $40 billion. The impact on Australian tax collection of a very small number of corporations is such that getting the amount of tax they pay right is of paramount importance to Australian tax revenues. Getting the allocation of that tax right between the jurisdictions in which they earn them is equally important. The Australian shareholders of these companies all benefit from dividend imputation, that is, they get a rebate of company tax paid when they include their dividends in their income. Dividend imputation means that company shareholders get benefits from the legal personhood of corporations without having to pay for those benefits. Any tax paid by the ‘person’ of the corporation is rebated back to the person of the shareholder.
Chapter 8 Company Tax in Other Jurisdictions

Introduction

This chapter examines company tax in the jurisdictions of the United States of America (‘US’) and Canada. Both these countries are federated states and were selected instead of unitary taxing states because, in these countries, companies pay tax at a federal/national level and at a state/provincial level. The issues of allocating company taxation between subnational jurisdictions have therefore been addressed by both the US and Canada. The attempts at harmonising the company taxing regimes of the various states that make up the EU are also examined, as is the progress of tax harmonisation in the EU.

Corporate global dominance in trade means that national taxing jurisdictions are dealing with tax shifting facilitated by transfer pricing. There is as yet no co-operation between countries in the collection of corporate income taxes. The EU, recognising the cost to tax revenues is working toward corporate tax harmonisation.

The provinces of Canada and the fifty States that constitute the US levy income tax on companies at Province and State level, called subnational taxation. This chapter will examine the experience of this subnational taxation of corporations. The Canadian and US experience of taxing corporations in different jurisdictions, albeit in one country, provides useful models as to the problems of sovereignty, profit shifting by corporations, information sharing and co-operation between jurisdictions. The subnational models can be applied to the problem of the international co-ordination of corporate income tax – sovereignty, levying and collection. This chapter will also examine the various alternatives for taxing the income of European Union resident corporations that are being discussed in the European Union (‘EU’).

In Australia the Constitution gives the power to tax to the States. The only specific power to tax that the Commonwealth has is the exclusive power to impose customs and excise duties. The Commonwealth however also has the power to make laws for taxation. This Commonwealth power is a residual power, because the States’ powers to legislate with respect to tax retain primacy over the Commonwealth power to legislate with respect to

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1013 Commonwealth of Australia Constitution Act, 1900, s90
1014 Ibid, s51(ii)
1015 Ibid, s107 Saving the power of State Parliaments and s108 Saving State laws.
tax (with the exception of customs and excise). In Australia the States relinquished their power with respect to income taxes to the Commonwealth in 1942. In the US as in Australia, the US federal governments’ power to levy taxes has been delegated to it by the States with the States retaining all the residual powers over taxation. In the US, unlike the Australian situation, the States in delegating taxation power to the federal government have retained their right to levy income taxes. The Australian states, on the other hand, entered into an agreement with the Commonwealth that, for practical purposes, left taxation as a right of the Commonwealth.

In Canada the taxation powers are split so that the federal government has unlimited powers of taxation and provincial powers to taxation are limited to the “direct taxation of income earned in the province and of income of persons resident in the province. At the present time, all the provinces impose personal and corporate income taxes.

The EU is grappling with the problem of the many tax jurisdictions in the Union countries and considering proposals for a uniform EU taxation system. This discussion has implications for the future of taxation sovereignty. The nations that make up the EU would be loathe to give up their sovereignty over taxation, as the Australian States have done, and the EU is therefore looking to the US and Canadian models of taxation.

The issues that arise when attempting to tax corporations subnationally, as is done in Canada and the US, are the same issues faced by the EU when attempting to harmonise the taxation of corporations in the many countries that make up the EU. This has implications world-wide with respect to attempting to impose taxes on multinational corporations. The main issues are those of the allocation of taxes between jurisdictions, the potential for tax shifting (transfer pricing), the problems of double taxation and sovereignty over taxation.

The fundamental risks attaching to either the subnational and supranational taxation of corporations, as detailed earlier, is the fact that corporations differ from natural persons in at least two respects that are particularly important for … income tax policy. First, the location of a corporation is not easily defined. The spatial location of an individual, at any moment in time, is

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1016 Thesis chapter 1
1018 Author’s emphasis
definite and, for most practical purposes verifiable. A corporation, by contrast, can simultaneously undertake economic activities in several of many places; moreover, although it may as a legal matter have a place of incorporation, its location, like its very existence, is a matter of judicial construction and interpretation, not an obviously verifiable matter of fact. Second, again unlike natural persons, corporations can merge, subdivide, or be acquired, dissolved, and restructured in many ways and to varying degrees. When legally distinguishable business entities are affiliated in some fashion, the question arises as to whether tax liabilities should be determined for each entity in isolation or for several in combination.\textsuperscript{1019}

The US and Canada in their experience of the subnational taxation of corporations have experience in managing these risks. The EU is considering these risks at the supranational level in their attempts to harmonise corporations’ tax.

**Company Taxation in the US**

**US Federal Company Taxation**

All entities organised under the various State Corporation laws must be taxed as corporations. Partnerships and limited liability companies may elect to be taxed as corporations. As well, publicly traded partnerships (unless earning qualifying passive income) will also be taxed as corporations. There are two types of corporation taxing regimes in the US, the

- C corporation and the
- S corporation

This classification essentially divides corporations into larger corporations where the ownership and management of the corporation are separate from each other (the C corporation) and smaller corporations (the S corporation). Smaller entities for the purposes of US tax law include partnerships, limited liability companies and sole proprietorships and are taxed as S corporations. The essential differences in the tax treatment between the two types of corporations are that:

1. C corporations pay entity taxation on their profits and shareholders do not benefit from dividend imputation as shareholders do in Australia. That is, shareholders in a C

\textsuperscript{1019} Wildasin DE, ‘State and Provincial Corporation Income Taxation Current Practice and Policy Issues for the US and Canada’, an earlier version of this paper was presented at the June 1999 meetings of the Canadian Public Economics Study Group, held at the University of Toronto, this paper written in the Department of Economics, Vanderbilt University, December, 1999 at pp2 and 3
corporation pay income tax on their dividends with no rebate for any income tax paid by the corporation.

2. S corporations (that is partnerships, limited liability companies and sole proprietorships) do not pay an entity level tax on their earnings. "There is no income tax on partnerships, or on limited liability companies treated as partnerships for Federal tax purposes. Nor (in most cases) is there an S corporation income tax or sole proprietorship income tax. Only the owners or members of these entities are taxed on their share of the entity’s earnings."1020 In other words, small corporations are effectively treated for tax purposes as though they were partnerships and not as separate legal entities.

At a Federal level in the US, the income tax legislation recognises that, as large companies have legal personhood separate from their shareholders so companies should be taxed on the company earnings and, shareholders of these companies are taxed on their earnings which include any dividends received from these companies.

In the US “an S corporation is a corporation that elects and is eligible to choose S corporation status and whose shareholders have all consented to the corporation’s choice. In general, an S corporation does not pay any income tax. Instead, the corporation’s income and deductions are passed through to its shareholders. The shareholders must then report the income and deductions in their own income tax returns.”1021 In the US therefore, companies that are essentially the business of a small group of individuals are not taxed, the corporate veil removed, and the shareholders are taxed as though they were partners in a business and not shareholders. The fact of incorporating a small business enterprise in the US still gives the shareholders the benefits of limited liability but not the taxation benefits associated with incorporation.

The 2007 US Master Tax Guide comments on the company taxing regime in these terms;

Of the types of business organization, C corporations are subject to the toughest tax bite. Their earnings are taxed twice. First a corporate income tax is imposed on its net tax earnings and then, after the earnings are distributed to shareholders as dividends, each shareholder must pay taxes separately on his or her share of the dividends.1022

1021 Ibid, p153
1022 Ibid, p133
This common view, that there is no legal distinction between companies and their shareholders, is espoused when it comes to the taxation of companies, but rarely when it comes to the liability of shareholders for liabilities incurred by companies. Commentators then point out that the liability of the shareholders is limited. The cost of limited liability must be the fact that companies are recognised as legal entities separate from their shareholders. There can be no question of ‘double taxation’ of company earnings. Companies are separate legal persons and should be taxed as such. Shareholders are also separate legal persons from the company in which they hold shares and should also be taxed separately. The cost of limited liability is this legal separation of the company from its shareholders.

Milton Friedman makes this error of not acknowledging the separate legal entity status of companies and goes further in condemning company taxes. Friedman believes that company taxes are “invisible taxes”1023. He goes on,

One thing we know is that a company can’t pay taxes. Only people can pay taxes. What a company can do is collect taxes. What happens is that a company collects taxes from its stockholder, from its workers and from its customers and turns over the proceeds to the government, but it does so in such a way that the workers and the stockholders and the customers hardly know they have paid taxes.1024

In other words, Friedman is saying that companies can’t pay taxes because all they do is pass monies (in the form of taxes) on to governments that the companies have deducted from shareholders’ dividends, workers’ pay packets and added to the prices of the goods that customers pay. What Friedman and many other commentators fail to acknowledge is the separate legal personhood of companies and the fact that the main aim of companies is to earn profits. These profits are distributed to shareholders and are the result of charging prices to customers sufficient to earn a surplus over the costs of production. If what Friedman says about companies is correct, that is, companies cannot pay taxes, it then follows that any person in business cannot pay taxes either. Using Friedman’s language it follows that:

What a business person can do is collect taxes. What happens is that a business person collects taxes from its profit share, from its workers and from its customers and turns over the proceeds to the government, but it does so in such a way that the

1024 Ibid
workers and the business owners and the customers hardly know they have paid taxes.

Friedman fails to acknowledge that companies can employ people, own property, runs business enterprises, sell products to customers (which may be people or companies) and make profits. It is out of these company profits that taxes are levies and paid.

Friedman is probably saying that income tax should only be levied on salaries but that profits shouldn’t be taxed.

US Federal Company Tax Rates
Federal corporate income tax rates are generally progressive with, what appear to be, incentives to increase taxable income at certain levels of corporate taxable income. The corporate income tax rates for 2007 are:\n
\[\text{Table 13}\]

\[\begin{array}{|c|c|c|}
\hline
\text{Taxable Income from \text{--} to} & \text{Tax is} & \text{Of the amount over} \\
\hline
$0 \text{--} $50,000 & 15\% & $0 \\
$50,000 \text{--} $75,000 & $7,500 + 25\% & $50,000 \\
$75,000 \text{--} $100,000 & $13,750 + 34\% & $75,000 \\
$100,000 \text{--} $335,000 & $22,500 + 39\% & $100,000 \\
$335,000 \text{--} $10,000,000 & $113,900 + 34\% & $335,000 \\
$10,000,000 \text{--} $15,000,000 & $3,400,000 + 35\% & $10,000,000 \\
$15,000,000 \text{--} $18,333,333 & $5,150,000 + 38\% & $15,000,000 \\
$18,333,333 & 35\% & $0 \\
\hline
\end{array}\]

“In addition to being liable for regular income taxes, every corporation … may be liable for the accumulated earnings tax. The tax is in the form of a penalty and applies if a corporation is formed or used for the purpose of avoiding the imposition of income tax upon the shareholders by permitting its earnings or profits to accumulate instead of being distributed.”\n
Corporate Income Tax levied by the US States
Most US States levy corporate income tax on companies that have a nexus to the state levying the tax. Some states allow a deduction for any federal taxes paid by the corporation. The required nexus for tax purposes varies between the states and “is normally established

\[\text{1025} \quad 2007 \text{ U.S. Master Tax Guide, as above, p136}\]
\[\text{1026} \quad \text{Ibid, p144}\]
when a corporation derives income from sources within the state, owns or leases property there, employs personnel there or has capital or property in the state.”
Table 14


<table>
<thead>
<tr>
<th>State</th>
<th>Income Tax (Range) %</th>
<th>Brackets</th>
<th>Comments</th>
<th>Federal Tax Deductible?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>6.5</td>
<td>flat rate</td>
<td></td>
<td>Yes</td>
</tr>
<tr>
<td>Alaska</td>
<td>1 to 9.4</td>
<td>10,000 to 90,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Arizona</td>
<td>6.968</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Arkansas</td>
<td>1 to 6.5</td>
<td>3,000 to 100,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>California</td>
<td>8.84</td>
<td>flat rate</td>
<td>1.5% for S corps</td>
<td>No</td>
</tr>
<tr>
<td>Colorado</td>
<td>4.63</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Connecticut</td>
<td>7.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Delaware</td>
<td>8.7</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Florida</td>
<td>5.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Georgia</td>
<td>6</td>
<td>flat rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hawaii</td>
<td>4.4 to 6.4</td>
<td>25,000 to 100,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Idaho</td>
<td>7.6</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>7.3</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Indiana</td>
<td>8.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Iowa</td>
<td>6 to 12</td>
<td>25,000 to 250,000</td>
<td>Yes (50%)</td>
<td></td>
</tr>
<tr>
<td>Kansas</td>
<td>4</td>
<td>flat rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kentucky</td>
<td>4 to 7</td>
<td>50,000 to 100,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Louisiana</td>
<td>4 to 8</td>
<td>25,000 to 200,000</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Maine</td>
<td>3.5 to 8.93</td>
<td>25,000 to 250,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Maryland</td>
<td>7</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Massachusetts</td>
<td>9.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Michigan</td>
<td>1.9</td>
<td>flat rate</td>
<td>Wide tax base</td>
<td>No</td>
</tr>
<tr>
<td>Minnesota</td>
<td>9.8</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Mississippi</td>
<td>3 to 5</td>
<td>5,000 to 10,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Missouri</td>
<td>6.25</td>
<td>flat rate</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Montana</td>
<td>6.75</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Nebraska</td>
<td>5.58 to 7.81</td>
<td>50,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>New Hampshire</td>
<td>8.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>New Jersey</td>
<td>9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>New Mexico</td>
<td>4.8 to 7.6</td>
<td>500,000 to 1m</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>7.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Nevada</td>
<td>Zero</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>North Carolina</td>
<td>6.9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>North Dakota</td>
<td>2.6 to 7</td>
<td>3,000 to 30,000</td>
<td>Yes</td>
<td></td>
</tr>
<tr>
<td>Ohio</td>
<td>5.1 to 8.5</td>
<td>50,000</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Oklahoma</td>
<td>6</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Oregon</td>
<td>6.6</td>
<td>flat rate</td>
<td>No</td>
<td></td>
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<tr>
<td>Pennsylvania</td>
<td>9.9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Rhode Island</td>
<td>9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>South Carolina</td>
<td>5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>South Dakota</td>
<td>6</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Tennessee</td>
<td>6.5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td>4.5</td>
<td>flat rate</td>
<td>On ‘earned surplus’</td>
<td>No</td>
</tr>
<tr>
<td>Utah</td>
<td>5</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Vermont</td>
<td>7 to 8.9</td>
<td>10,000 to 250,000</td>
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<td></td>
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<tr>
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<td></td>
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<tr>
<td>West Virginia</td>
<td>9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
<tr>
<td>Wisconsin</td>
<td>7.9</td>
<td>flat rate</td>
<td>No</td>
<td></td>
</tr>
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<tr>
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<td></td>
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</tr>
<tr>
<td>Wyoming</td>
<td>Zero</td>
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</tr>
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</table>

In 1957, the US National Conference of Commissioners on Uniform State Laws recognised that the “need for a uniform division of income for tax purposes among the several taxing jurisdictions (in the US) has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results.”

The National Conference drafted a Uniform Division of Income for Tax Purposes Act (‘UDITPA’) that proposed the adoption by all the US states of a “three factor formula” for determining business income for each state. The formula adopted was:

Section 9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

The UDITPA also defines all the terms of the formula. The numerators of the formula are defined as follows:

- The property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer’s real and tangible personal property owned or rented and used during the tax period.

- The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period.

- The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

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1029 The National Conference of Commissioners on Uniform State Laws, Uniform Division of Income for Tax Purposes Act, drafted and approved at the Annual Conference meeting, New York, New York, July 8 –13, 1957, prefatory note.
1030 Ibid
1031 Uniform Division of Income for Tax Purposes Act, as above, Section 9
1032 Ibid, Section 10
1033 Ibid, Section 13
1034 Ibid, Section 15
This attempt at uniformity recognised that the above formula may not “fairly represent the extent of the taxpayer’s business” in the state. In this case the UDITPA provides that “the taxpayer may petition for or the [tax administrator] may require, in respect to all or any part of the taxpayer’s business activity, if reasonable:

(a) Separate accounting;
(b) The exclusion of any one or more of the factors;
(c) The inclusion of one or more additional factors which will fairly represent the taxpayer’s business activity in this state; or
(d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer’s income.  

In 2005 the most common formula used in the states was actually the ‘double-weighted sales formula’ where the weight on the sales factor is twice the weight on the property and payroll factors. The UDITPA recommendation placed equal weight on each of the factors.

The UDITPA formula would apportion company profits thus:

\[ \text{State Profits} = \left[ \frac{1}{3} \left( \frac{\text{property in state}}{\text{total property}} \right) + \frac{1}{3} \left( \frac{\text{payroll in state}}{\text{total payroll}} \right) + \frac{1}{3} \left( \frac{\text{sales in state}}{\text{total sales}} \right) \right] \times \text{total profits} \]

The most common formula to apportion profit between states, actually used in 2005 was:

\[ \text{State Profits} = \left[ \frac{1}{4} \left( \frac{\text{property in state}}{\text{total property}} \right) + \frac{1}{4} \left( \frac{\text{payroll in state}}{\text{total payroll}} \right) + \frac{1}{2} \left( \frac{\text{sales in state}}{\text{total sales}} \right) \right] \times \text{total profits} \]

Even though this was the most common formula used, not all states weighted each of the factors this way, and some states excluded property and payroll from the formula.

The UDITPA could only have had a reasonable chance of success if all the states had uniformly adopted the proposal AND had adopted the same rate of taxation. Adoption of the proposal with differing tax rates would provide corporations with the incentive required to challenge the formula to shift income ‘earned’ to low or no taxing states. UDITPA was

1035 Ibid, Section 18
1036 Ibid, Section 18
1038 Ibid, p34
1039 Ibid, p44

242
adopted but, “not all states with income taxes have adopted it, some states that have adopted UDITPA deviate from it in significant ways or interpret its provisions differently…”

As can be seen from the above table of the State Income Tax Rates for 2006 there is no uniformity between the US States as to tax rates.

Lack of uniformity in taxation between the states has lead to major problems. The three major problems identified by tax commentators in the US are;

1. Economic inefficiency – “differences across states in corporate income tax systems lead to interstate differences in effective tax rates on the return to capital.”

2. Tax competition between the states.

3. The cost of tax compliance – it has been estimated that the cost of complying with US federal company tax rules is approximately 1.4% of the tax liability, while complying with state tax laws costs approximately 2.9% of taxes.

The lack of uniformity in taxation between the states has been a “major issue”, especially for corporate taxpayers, since corporate taxpayers are more likely than individuals to operate in more than one state, since state corporate income taxes were first introduced in Wisconsin in 1911. By 1930 sixteen US states had adopted corporate income tax. The issue of state corporate income taxes lead to the “business community” lobbying the US Congress for some uniformity. As a result of this lobbying a committee, the Willis Committee, was established to consider uniformity of state corporate taxation. This committee reported in 1965, concluding;

It has been found that the present system of State taxation as it affects interstate commerce works badly for both business and the States. It has also been found that the major problems encountered are not those of any one of the taxes studied but rather are common to all of them. This is not surprising in that all of these problems reflect the pervasive conflict between the approach of the taxation of interstate companies as is appears in state and local law, and the practical difficulties of

\[\text{\textsuperscript{1042}}\text{ Ibid}\]
\[\text{\textsuperscript{1043}}\text{ Ibid}\]
\[\text{\textsuperscript{1044}}\text{ Ibid}\]
\[\text{\textsuperscript{1045}}\text{ Ibid}\]
\[\text{\textsuperscript{1046}}\text{ Ibid}\]
realistic compliance expectations and effective enforcement. Increasingly the States, reinforced by judicial sanction, have broadened the spread of tax obligations of multistate sellers. As the principle of taxation by the State of the market has been accepted, the law has prescribed substantially nationwide responsibility for more and more companies. The expanding spread of tax obligations has not, however, been accompanied by the development of an approach by the States which would allow these companies to take a national view of their tax obligations. The result is a pattern of State and local taxation which cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States.\textsuperscript{1047}

Despite the fact that US state corporate taxation ‘cannot be made to operate efficiently and equitably when applied to those companies whose activities bring them into contact with many States,’ the states are loathe to consider giving up their sovereignty by agreeing to uniform taxation. This is even though the states are losing revenues by the manipulation of the formulary apportionment to avoid paying all or part of their taxation liabilities. This dilemma of the states was expressed as follows

individual states must be willing to sacrifice sovereignty in order to increase the collective sovereignty of all states.\textsuperscript{1048}

These are the same problems faced by national jurisdictions around the world when those national jurisdictions attempt to tax multinational corporations.

The UDITPA formula for apportioning tax is a mechanistic and crude attempt to apportion taxes between jurisdictions. The formula does not take into account externalities produced by the corporation in earning income. The formula does not take into account the different business activities undertaken by corporations and the impact that would have on the formula. For example, a business may operate out of leased premises and have relatively low property values in a jurisdiction even though it may have a large physical impact. However, the UDITPA formula does take account of three important physical factors employed in earning profits, labour, sales and property. The formula does take account of ‘real’ factors of production and does attempt to link those factors with a locality, or taxing jurisdiction. The UDITPA formula is also easy to apply resulting in relatively low compliance costs (as

\textsuperscript{1047} Ibid
\textsuperscript{1048} McLure CE, ‘Understanding the Nuttiness of State Tax Policy: When States Have Both Too Much Sovereignty and Not Enough’, \textit{National Tax Journal}, as above
opposed to the costs of instituting transfer pricing\textsuperscript{1049} for the taxpaying corporation. The formula would also be transparently verifiable by taxing authorities unlike the transfer pricing rules.

**Company Taxation in Canada**

The Canadian Constitution gives the federal government unlimited powers of taxation. The provinces also have the power to impose taxes, but their power is limited to the “direct taxation of income earned in the province and of income of persons resident in the province.”\textsuperscript{1050} In 2005 all the provinces imposed personal and corporate income taxes.\textsuperscript{1051} Of the 13 provinces and territories in Canada only Quebec collects its “personal and corporate income taxes, and Ontario and Alberta collect their corporate income tax. All other taxes are collected on behalf of the provinces by the Federal government.”\textsuperscript{1052} All corporations resident in Canada are subject to “Canadian tax on its taxable income derived from sources both within and without Canada.”\textsuperscript{1053} Federal corporate tax rates are generally flat rates of tax with every dollar of corporate income subject to tax\textsuperscript{1054}.

The General federal tax rate is 38%. However, this rate is reduced by a provincial rebate of 10%, increased by a general federal rate of 1.12% and reduced by a ‘general rate reduction from 1% in 2001 increasing to 9% in 2010.

**Table 15**

**Canadian General Federal Tax Rate**\textsuperscript{1055}

|----------|------|------|------|-----------|------|------|------|

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>$200,000</td>
<td>$225,000</td>
<td>$250,000</td>
<td>$300,000</td>
</tr>
</tbody>
</table>

There is some progressivity in the Canadian corporate tax rates for Canadian Controlled Private Corporations (‘CCPC’). These corporations are entitled to a lower rate of taxation up to what is called a small business deduction rebate. The CCPC taxation rate is 13.12% at the following thresholds;

$200,000  $225,000  $250,000  $300,000

\textsuperscript{1049} Chapter 6
\textsuperscript{1050} Canadian Master Tax Guide 60th Edition, 2005, as above, p4
\textsuperscript{1051} Ibid
\textsuperscript{1052} Ibid
\textsuperscript{1053} Ibid, p531
\textsuperscript{1054} Canadian Income Tax Act with Regulations 81st edition, 2006 March, published by CCH, Canada, Tables of Rates and Credits, p xiii
\textsuperscript{1055} Ibid
However, this small business rebate is only applied to “active business income, earned in Canada, of associated CCPC’s, up to a threshold. …the small business deduction is reduced if taxable paid-up capital employed in Canada, on an associated basis, exceed $10 million in the preceding year.”

The federal corporate tax rates used to distinguish between income that was derived from manufacturing and processing (‘M&P’) and other corporate income. Income derived from M&P was taxed at a rate less than other income, presumably to bolster manufacturing and processing in Canada. This difference is no longer evident in the federal corporate tax rate, but it is still evident in some of the provinces.

In addition to the General federal tax rate, above, there are a number of other federal corporate tax rates.

Other Federal Corporate Tax Rates for 2006

1. Income not earned in a province or territory, rate 32.12%
2. Branch tax, imposed on non-resident corporations, rate 25%
3. Refundable Part IV tax payable on taxable dividends received from certain taxable Canadian corporations, rate 33.33%
4. Refundable investment tax, imposed on the investment income of CCPC’s, rate 6.66%
5. Large corporations tax, imposed on taxable capital employed in Canada over $50 million, rate 0.125%
6. Part IV Financial Institution Capital Tax, imposed on banks, trust and loan and life insurance companies with capital employed in Canada over $300 million, rate 1.25%

Corporate Income Tax Rates by Province

In addition to the federal corporate income tax, all Canadian corporations pay provincial and/or territory tax on income allocated to their particular province or territory.

Companies with a presence in Quebec must lodge returns and pay tax to the Quebec government. Companies with a presence in the other provinces lodge only one return, to the Federal Government, and pay all their taxes to the Federal government. The Federal government distributes the tax due to the provinces using an apportionment formula.

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1056 Ibid, p xiv
1057 Ibid, p xv
1058 Ibid
1059 Ibid, p xvi
The Canadian formula for distributing company profits between the provinces is used by all of the provinces (unlike the US formula) and applies “a payroll and sales formula with each factor weighted by one-half.”

In Canada provincial profits equal:

\[
\text{Provincial Profits} = \left[ \frac{1}{2} \left( \frac{\text{payroll in province}}{\text{total payroll}} \right) + \frac{1}{2} \left( \frac{\text{sales in province}}{\text{total sales}} \right) \right] \times \text{total profits}
\]

Table 16

**Canadian Corporate Income Tax Rates by Province – 2006 %**

(General and M&P Corporate Income Tax Rates)

<table>
<thead>
<tr>
<th>Province/Territory</th>
<th>General Rate</th>
<th>M&amp;P Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alberta</td>
<td>11.5</td>
<td>11.5</td>
</tr>
<tr>
<td>British Columbia</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Manitoba</td>
<td>14.5</td>
<td>14.5</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>13</td>
<td>13</td>
</tr>
<tr>
<td>Newfoundland and Labrador</td>
<td>14</td>
<td>5</td>
</tr>
<tr>
<td>Northwest Territories</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Nova Scotia</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>New Brunswick</td>
<td>12</td>
<td>12</td>
</tr>
<tr>
<td>Ontario</td>
<td>14</td>
<td>12</td>
</tr>
<tr>
<td>Prince Edward Island</td>
<td>16</td>
<td>16</td>
</tr>
<tr>
<td>Quebec - Active eligible</td>
<td>9.9</td>
<td>9.9</td>
</tr>
<tr>
<td>- Other</td>
<td>16.25</td>
<td>N/A</td>
</tr>
<tr>
<td>Saskatchewan</td>
<td>17</td>
<td>10</td>
</tr>
<tr>
<td>Yukon</td>
<td>15</td>
<td>2.5</td>
</tr>
</tbody>
</table>

The Canadian provinces and territories, in each imposing corporation’s income tax, face the same problems of economic inefficiency, tax competition between provinces and territories and the cost of tax compliance as do the various states of the US. However, unlike the US and like Australia, Canadian shareholders enjoy the benefit of dividend imputation which was introduced in Canada in 1973.

**Company Taxation in the European Union**

The European Union, also called the European Community, (‘EU’) is a grouping of 27 independent countries with a population of 490 million people “committed to working

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1060 Martens-Weiner J, *Company Tax Reform in the European Union*, as above, p34
1061 Ibid
together for peace and prosperity.”  

Even though the member states of the EU all retain their national sovereignty, they “have set up common institutions to which they delegate some of their sovereignty so that decisions on specific matters of joint interest can be made democratically at the European level.”

The aims of the European Community are to promote throughout the Community a harmonious, balanced and sustainable development of economic activities, a high level of employment and of social protection, equality between men and women, sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States.

The major achievements of the EU have been the

- establishment of a single market,
- permitting EU citizens to live, work, study and retire in another EU country and
- the establishment of a single currency, the Euro. The Euro has been adopted by 12 of the 27 EU member states.

The single market was one of the original aims in establishing the EU in the aftermath of the Second World War. However, it was not until 1985 that the single market project was established. The project has worked continuously and intensely towards removing barriers to the single EU market and the major tasks of the project were completed by 1993.

Establishing a single market involved more than abolishing tariffs and quotas on goods moving between EU countries it also meant the adoption of “hundreds of directives needed to sweep away the technical, regulatory, legal, bureaucratic, cultural and protectionist

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1064 Ibid
1067 Ibid
barriers”1068. The goal of a single European market has not yet been completely achieved, in particular, in the financial services and transportation sectors1069.

Even though the task of establishing a single market was daunting in its complexity and is not yet complete it has, “according to the Commission, created 2.5 million jobs since 1993 and generated more than €800 billion in extra wealth.”1070 In other words, EU harmonisation and working towards goals of a united Europe is a process, not a task to be achieved. The process of establishing a single market has been underway for the 50 years of the EU’s existence.

The EU has largely achieved mobility between member states for its citizens. The lack of labour mobility has been one of the singular failures/anomalies of globalisation.

The process of a adopting a single EU currency has been underway for less than 10 years. The fact that the single European currency has been adopted by only 12 EU members does not mean that the Euro has not succeeded, but that the process is succeeding in achieving results.

**EU Corporate Taxation**

There is no EU corporate taxation system. Each of the members of the EU has retained sovereignty over company taxation and each member operates their own national company-taxing regime. This is despite the fact that “corporate tax coordination, including rate harmonisation, has been the subject of intense discussion in the European Union for many years”1071. All of the member countries of the EU tax companies using profits as the base upon which to levy tax. Most of the member countries also use the “separate accounting, arm’s length principle”1072 (transfer pricing) to calculate company profits and to levy tax. Calculating profit is central to calculating tax payable. As shown in chapter 6 of this thesis, calculating company profits is an artificial construct open to manipulation. Attempting to determine company profits using arm’s length principle, as observed by Martin and Schumann, is not possible in many cases because “it cannot be proved whether the prices in

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1069 Ibid
1070 Ibid
1072 Martens-Weiner J, *Company Tax Reform in the European Union*, as above, pxi, Foreword written by Joseph H Guttentag former Deputy Assistant Secretary US Department of the Treasury
intra-firm trade are too high or not, because comparable prices scarcely exist for many of the items in question.” 1073

In response to this ability by companies to shift profits between taxing jurisdictions the EU is now considering proposals to “adopt the formulary approach to deal with the taxation of inter and intra company transactions” 1074 as used in the US and Canada.

The objective of European taxation policy “is not to standardise the national systems of compulsory taxes and contributions but simply to ensure that they are compatible not only with each other but also with the aims of the Treaty establishing the European Community.” 1075

The stated aims of the EU and the objectives of European taxation policy are a contradictory mix. On the one hand the EU wants to promote ‘social cohesion and solidarity among Member States’ while at the same time promoting ‘a high degree of competitiveness’. The taxation policy objectives also suffer from contradiction. The stated taxation objective ‘is not to standardise the national systems of compulsory taxes and contributions but simply to ensure that they are compatible’. How to achieve a taxation policy that is compatible but not standardised is a difficult objective. However, creating a single market, labour mobility and a single currency were just as difficult, but have had success.

The EU recognises that “(t)axation is central (author’s emphasis) to national sovereignty, for without revenue government cannot conduct policy.” 1076 The EU has categorised three main types of taxes,

1. Direct taxes; those paid and borne by the taxpayer, such as income taxes, wealth taxes and most local government taxes.
2. Indirect taxes; taxes levied on production and consumption, where the ‘person’ paying the tax has merely collected the tax from the consumer on whom the tax burden falls. The most common form of this tax is GST called VAT in Europe.
3. Social security contributions; compulsory charges paid by employers and employees to pay for sickness, disability or unemployment benefits. 1077

1073 Martin H-P and Schumann H, The Global Trap, as above, p199
1074 Martens-Weiner J, Company Tax Reform in the European Union, as above, pxi
1075 European Commission, Tax Policy in the European Union, published by European Communities, Belgium, 2000, p5
1076 Ibid, p3
1077 Ibid, p5
compulsory social security contributions paid in Australia are the Medicare levy and superannuation.

When the EU initially considered taxation policy, it was directed only to the harmonisation of indirect taxes. The Treaty Establishing the European Community, signed in Rome in 1957, Title VI, Chapter 2 ‘Taxation Policy’ only considered the harmonisation of indirect taxes. It became clear that the one internal European market could not sustain different indirect tax regimes because “differences in tax rates on various goods tended to divert business; and the resultant skewing of production and distribution can have wider social repercussions.”\(^{1078}\) In other words, harmonisation of indirect taxes was seen as essential to the EU goal of a single market.

There was not considered to be the same need to harmonise direct taxes because differing direct taxes between EU members was not considered an obstacle to the single market objective. However, it was found that tax competition between member states “puts downward pressure on the level of tax and contributions which may be damaging if it is not regulated, as it undermines the fairness and overall efficiency of tax systems.”\(^{1079}\) This downward pressure has been called ‘the race to the bottom’ by many commentators.

Corporate income tax rates in the EU have declined from an average rate of 38.0% in 1995 for the EU 15 member states\(^{1080}\) to 30.6% in 2005\(^{1081}\). The race to the bottom has been more marked in the ‘newer’ 10 EU states\(^{1082}\) where the corporate income tax rate declined from an average of 30.6% in 1995 to 20.6% in 2005\(^{1083}\).

In the area of company taxation it was found that “(w)ith increasing mobility and differentials in tax bases, businesses can identify the components on which they are taxed (taxable bases) and shop around to find the country where tax is lowest.”\(^{1084}\) Even though the EU has been discussing the need to harmonise corporate taxes since 1962\(^{1085}\) all attempts at harmonisation have failed. In the words of the EU, “(a)tempts to harmonise corporation tax

\(^{1078}\) Ibid, p3  
\(^{1079}\) Ibid, p9  
\(^{1080}\) The EU 15 member states are the ‘older’ EU states of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.  
\(^{1081}\) Martens-Weiner J, Company Tax Reform in the European Union, as above, p19  
\(^{1082}\) The 10 ‘new’ EU member states are Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.  
\(^{1083}\) Martens-Weiner J, Company Tax Reform in the European Union, as above, p19  
\(^{1084}\) European Commission, Tax Policy in the European Union, published by European Communities, Belgium, 2000, p9  
\(^{1085}\) Ibid, p24
(1975), the rules governing the carry-over of losses (1984 and 1985) and the tax bases for companies (1980) has failed.”\textsuperscript{1086} These attempts at corporate taxation harmonisation failed because member states did not take up these suggestions because of a fear of losing taxation sovereignty. There are differing concepts of sovereignty and taxation sovereignty is only one form of sovereignty.

The different concepts of sovereignty articulated by Quiggan (citing Kazan)\textsuperscript{1087} are:

- International legal sovereignty – the acceptance of a state as a member of the international community,
- Westphalian sovereignty – the principle that one sovereign state should not interfere in the domestic arrangements of another,
- Interdependence sovereignty – the capacity and willingness to control flows of people, goods, and capital into and out of a country, and
- Domestic sovereignty – the capacity of a state to choose and implement policies within a territory.\textsuperscript{1088}

Other authors adopt other concepts of sovereignty. For example, Drahos and Braithwaite recognise parliamentary sovereignty, national sovereignty and citizen sovereignty\textsuperscript{1089}.

Concerns about losing sovereignty over taxation appear to be concerns about losing domestic or parliamentary sovereignty.

Even though there is a recognised need (recognised by the continuing support for work towards taxation harmonisation) and recognised advantages for the member sovereign States of the EU to harmonise their corporation taxes this process is not yet far advanced because of member state concerns about losing domestic or parliamentary sovereignty.

\textit{EurActiv}, an EU newsletter, reported on 2 May 2007 that even though a “common consolidated corporate tax base (‘CCCTB’) was initially voiced in a 2001 Communication … progress has been slow due to member states’ reluctance to allow the Commission to encroach upon their national sovereignty in this area.”\textsuperscript{1090} Even though the CCCTB has been

\textsuperscript{1086} Ibid
\textsuperscript{1088} Ibid
\textsuperscript{1090} ‘Commission plans EU company tax despite opposition., \textit{EurActiv}, 2 May, 2007, \url{http://www.euractiv.com}, accessed 14/5/07
considered from as recently as 2001, the EU has been considering tax harmonisation since 1962.\textsuperscript{1091} As noted above, the US has attempted to adopt the standard UDITPA formula apportionment for company profits since 1957 with only limited success.

EU member states and other countries have already had their sovereignty over taxation limited in many ways. For example, the widespread use of double tax agreements (‘DTAs’) is a loss of Parliamentary sovereignty. DTAs are bilateral agreements between two countries that aim to avoid double taxation between the two countries that are party to the agreement and minimise tax avoidance by residents of either country.\textsuperscript{1092} DTAs attempt to avoid double taxation between countries by resolving the question of a taxpayers’ residency, and the source of income, for the purposes of taxation. DTAs attempt to minimise tax avoidance by imposing withholding tax on dividend, interest, royalties and certain other business payments. DTAs curtail domestic or parliamentary sovereignty by:

- Delegating parliamentary sovereignty to the civil servants drafting the agreements,
- Providing that if there is a conflict between the domestic law and the terms of the DTA, the DTA will prevail,\textsuperscript{1093} and
- Delegating the interpretation of any terms in dispute in a DTA to the interpretation rules of the Vienna Convention\textsuperscript{1094}.

DTAs are not rare exceptions to domestic tax law. Australia, for example, is a party to “47 DTAs which include most of Australia’s trading partners.”\textsuperscript{1095} Australia is not unusual in entering into DTAs, in fact the Australian ‘model DTAs’ “are based on a common model, the OECD Model Tax Convention on Income and on Capital”\textsuperscript{1096}.

DTAs are not the tip of the iceberg when considering encroachments to sovereignty. DTAs are a part of the multiple challenges to sovereignty.

Globalisation of economic organisation, transnational commerce, culture and travel, and the new communications media… challenges the effective political capacity of

\textsuperscript{1093} Ibid, p700
\textsuperscript{1094} Ibid In the case of \textit{Thiel v FCT}, HC (1990) 21 ATR 531, the High Court held that a DTA “agreement is a treaty and is to be interpreted in accordance with the rules of interpretation recognised by international lawyers”, vis the Vienna Convention, even as in this case where one of the parties to the agreement in dispute, Switzerland, was not a party to that convention.
\textsuperscript{1095} Ibid
\textsuperscript{1096} Ibid
the state. And, in large part in response to, and as a means to contain and capture the collective action problems precipitated by these movements, we see the growth of polities which are not states but which rival states in terms of legal and political authority – paradigmatically the EU, but also international organisations such as the Council of Europe, UN, WTO etc.\textsuperscript{1097}

Globalisation of economic organisation has already seriously compromised the sovereignty of nation states. Paradoxically, nation states attempting to assert sovereignty over multinational corporations will increasingly have to resort to the use of international organisations.

Despite member state fears of losing taxation sovereignty, there have been some small successes in the harmonisation process. These successes include the following directives;

1. “Council Directive 77/799/EEC which provides for mutual assistance between tax authorities”\textsuperscript{1098} to help in tax collections,

2. Merger Directive 90/434/EEC “designed to cut down tax measures that might hamper business reorganisation.”\textsuperscript{1099}

3. Parent-subsidiary Directive 90/435/EEC which “abolishes double taxation of profit distributed between parent companies in one Member States and their subsidiaries in another Member State.”\textsuperscript{1100}

4. Convention 90/436/EEC which introduced “an arbitration procedure to prevent double taxation in connection with the adjustment of profits between associated enterprises from different Member States.”\textsuperscript{1101}

The process of corporate tax harmonisation in the EU took another step forward on 2 May 2007 when the EU Taxation Commissioner, Laszlo Kovaks presented a “second Communication on progress towards harmonising national tax systems for companies”\textsuperscript{1102}. This Communication was adopted by the Commission of the European Communities on the 2\textsuperscript{nd} May 2007\textsuperscript{1103} despite continued opposition from Estonia, Britain and Ireland\textsuperscript{1104}.


\textsuperscript{1098} European Commission, \textit{Tax Policy in the European Union}, as above, p25

\textsuperscript{1099} Ibid

\textsuperscript{1100} Ibid

\textsuperscript{1101} Ibid

\textsuperscript{1102} ‘Commission plans EU company tax despite opposition., \textit{EurActiv}, 2 May, 2007, \url{http://www.euractiv.com}, accessed 14/5/07

\textsuperscript{1103} Ibid

Opposition to the CCCTB has weakened since the first progress report was tabled in 2006 when seven countries were opposed. At the recent debate on the CCCTB “Kovaks made it clear that he would not allow the veto power of a few countries to block his (CCCTB) project. He said that he would envisage, ‘as a last resort’, going ahead with a pioneer group of states, under the so-called enhanced co-operation mechanism. This would allow a minimum of eight states to push forward with the initiative even if it were blocked by others.”

The EU Taxation Commissioner, Kovaks, has no doubts about the continuing process of corporate tax harmonisation and the eventual adoption of the CCCTB in the EU. The CCCTB project is conducted by a working group of member state experts in consultation with business practitioners and academics meeting quarterly. The working group is currently split into six sub-groups to deal with particular issues. These sub-groups are dealing with

- Assets and depreciation,
- Provisions and reserves,
- Taxable income,
- International aspects,
- Group taxation and
- The profit sharing mechanism.

The concerns of the CCCTB working group discussions have all been based on determining the profitability of the affected corporations. Once the CCCTB has been determined the working groups acknowledge that they will need to consider the basis on which the CCCTB will be shared between the relevant EU members and the administrative and judicial framework of the CCCTB.

The EU is seriously canvassing the use of formulary apportionment as is used in the US and Canada. The EU recognises the problems of applying transfer pricing guidelines and the opportunities for tax shifting that they provide. EU taxing authorities recognise that

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1105 ‘Commission plans EU company tax despite opposition’, EurActiv, 2 May, 2007, [http://www.euractiv.com](http://www.euractiv.com), accessed 14/5/07. The countries opposed to the CCCTB in 2006 were Ireland, Britain, Lithuania, Latvia, Slovakia, Malta and Cyprus.
1106 Ibid
1107 Commission of the European Communities, *Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee*, Brussels, 2.5.2007, p4
1108 Ibid, p6-8
Multinational enterprises appear increasingly able to shift income inappropriately to low-tax areas, and the empirical evidence suggests that multinational enterprises do take advantage of the cross-border tax differentials to shift income.\footnote{Martens-Weiner J, \textit{Company Tax Reform in the European Union}, as above, p25}

The fact that EU taxing authorities recognise the opportunities for tax shifting by applying transfer pricing rules gives rise to the expectation that multinational corporations would prefer to retain the transfer pricing rules. However, Martins-Weiner found that “EU businesses are increasingly critical of the process of establishing transfer prices for tax purposes.”\footnote{Ibid, p5} This is because they

Have to determine what prices could be regarded as arm’s length, to find comparables, put the related documentation together, defend these prices, incur the related compliance costs and run the risk of double taxation.\footnote{Ibid Double taxation in this context refers to the possibility of a company paying tax on company profits in more than one taxing jurisdiction.}

The Commission of the European Communities reported on the various issues discussed in the CCCTB working group meetings\footnote{Commission of the European Communities, \textit{Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee}, Brussels, 2.5.2007, Annexes, pp9 and 10}. These are listed below to give an understanding of the depth and breadth of issues relevant to a CCCTB and under discussion.

1. The deductibility of certain items related to specific domestic situations such as social contributions and taxes other than corporate income taxes.
2. The main principle for the taxation of residents (world-wide or territorially) and how double taxation should be eliminated (credit or exemption method).
3. The definition of the CCCTB group for consolidation and the mechanism for consolidating the group companies. In particular the group considered which related companies should be permitted or required to consolidate their profits and losses and how intra-group transactions should be eliminated to avoid arms-length pricing complexities.
4. Fixed assets and depreciation
5. Deductions for provisions
6. The general methodology for determining the tax base of a company
7. The tax deductibility of local taxes
8. The treatment of foreign income
9. A detailed definition of what constitutes a group of companies for the purposes of consolidation

10. Methods of eliminating intra-group transactions to avoid the problems of transfer pricing.

11. The profit sharing mechanism to be adopted. The working group is considering whether a macro, value added, formula or combination approach should be adopted.

The CCCTB working group meetings are adopting a methodical and pragmatic approach to the taxation of corporations. The hurdles to a CCCTB, as can be seen from the above list, are accounting issues and taxation issues. The accounting issues are of consolidation, profit recognition, and accounting policies. As was seen in Chapter 3 Kovaks, in May 2007, stated that the general methodology for determining the tax base of a company was determining its accounting profit.

The initial starting point for determining the tax base of a company may be by reference to the comparison of opening and closing balance sheets or by reference to the profit and loss account of the company.\footnote{Commission of the European Communities, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, Brussels, 2.5.2007, p9}

The EU has established an IASB in order to impose harmonised accounting standards to all companies operating in the EU. These international accounting standards have already been successful in getting major corporations to report their profits using international standard uniform reporting rules. The review of Australia’s largest companies in Chapter 7 revealed that of the 43 companies examined, 41 prepared their accounts using Australian equivalents to International Financial Reporting Standards (‘AIFRS’), one company, BHP Billiton Limited, prepared its accounts using International Financial Reporting Standards (‘IFRS’) and only one company, Macquarie Bank Limited prepared its accounts using Australian Accounting Standards.

The taxation issues that have been identified by the CCCTB working group will be more difficult to accommodate because they raise issues of national sovereignty over the taxation of corporations. The taxation issues are the fundamental ones of determining the tax base of a company and all the rules, depreciation, trading stock valuation etc that go to making up a tax base.
The EU is continuing to move to corporate tax harmonisation even though a number of member states are resistant to the process. In EU fashion the tax harmonisation can occur between consenting states and other states can enter the process at a later date, or not, as occurred with currency harmonisation in the EU. Adopting the formula apportionment method for allocating company profits between taxing jurisdictions reduces the need for complete tax harmonisation. As the US and Canadian experience demonstrates, formula apportionment allows the taxing jurisdictions to retain substantial sovereignty over taxation.

**Conclusion**

The US and Canada both tax companies at a national and subnational level. Both countries use a formula approach to allocate profits between the taxing jurisdictions where the companies paying tax have activities. These formulas are not consistently applied between the subnational taxing jurisdictions. The formulas provide only a very rough approximation of corporate activity taking place in a taxing jurisdiction because of the few indicators of activity used, that is, employees, property and sales. The US and Canadian taxing authorities, although well aware of the limitations of the formula approach, continue to use the formulas to allocate profits. The EU is also considering applying the formula approach to profit and tax allocation between the national taxing jurisdictions making up the EU.

The advantage of the formula approach, as opposed to transfer pricing, is that it is relatively transparent and simple to apply and to administer. Even though the approach can in no way be seen as a sophisticated measure of the activity of a corporation in a particular jurisdiction the formula is grounded in measures of physical activity unlike transfer pricing. The other advantage of formula allocation is that the various taxing jurisdictions retain sovereignty over the taxation of the formula ‘allocated’ profits. As can be seen from the US and Canadian experience, the different subnational taxing jurisdictions can and do apply different company tax rates to the company profits ‘earned’ in their jurisdiction.

Another advantage of using the formula apportionment method is that eliminates the possibility of multinational corporations paying double tax on their profits. The entire consolidated profit of a multinational corporation is allocated between taxing jurisdictions and subject to the tax applicable to that jurisdiction.

The US tax law makes a distinction between corporations and the way they are taxed. The US recognises that major corporations do have a distinct legal personality from their shareholder and do not apply dividend imputation. The US also recognises that smaller
corporations are not legally distinct from their ‘owners’ and so no tax is applied to these companies. In the case of the small corporation the corporate veil is moved aside and the financial activities of the corporation, sales, expenses, profits and losses are allocated to the shareholders who are taxed accordingly.
Chapter 9 Taxing Alternatives

Globalisation and Human Rights

Globalisation includes “the international flow of ideas and knowledge, the sharing of cultures, global civil society, and the global environmental movement.” According to Stiglitz economic globalisation “entails the closer economic integration of the world through the increased flow of goods and services, capital and even labour.” These definitions do not include the idea of global taxes. In order to provide a ‘global civil society’ taxes will need to be raised globally. Additionally, economic globalisation does not extend to the movement of labour which is still bound to sovereign states. Borders between countries are free to all manner of goods, services, information and money but not to people. This is a “logical inconsistency of free capital mobility without corresponding labour mobility.”

This inconsistency has narrowed the concept of national sovereignty to that of border control. And border control is now almost exclusively a reference to the control of the movement of people and the resulting global refugee crisis is a symptom of this unbalanced globalisation.

“In 1951, when the UNHCR was established, there were an estimated 1.5 million refugees worldwide. On 1 January 2000, the UNHCR considered 22.3 million people to be ‘of concern’. They included 11.7 million refugees, 1.2 million asylum seekers, 2.5 million repatriated refugees and 6.9 million internally displaced persons and others of concern. Another 13 – 18 million internally displaced persons were outside the UNHCR’s jurisdiction, as were an estimated 3.5 million Palestinians. This gives a total of 43 million.”

In 1959 when the world population was estimated at 3 billion people and there were an estimated 1.5 million refugees there was 1 refugee for every 2,000 people in the world. Now, with the world population estimated at 6.5 billion people there are 43 million people of

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1115 Ibid
1116 Mann S, Economics, business ethics and law, published by the Lawbook Co., Australia, 2003, p115
1117 The United Nations High Commissioner for Refugees (‘UNHCR’)
1120 Ibid, estimate of world population as at 21 November 2006.
concern to the UNHCR. This means that there is 1 person for every 151 persons in the world today, who is either a refugee or a person of concern. Today, therefore, there are 13 times as many people living in the world as refugees or persons of concern than there were 50 years ago.

Although these numbers are estimates and not directly comparable, they do provide a very strong indication that there is a ‘refugee crisis’ in the world today. And, even though this crisis may not be directly caused by the liberalisation of markets, the refugee crisis is indicative of another worldwide trend. That is, the trend of nations “to guard their political sovereignty”\textsuperscript{1121} by controlling the flow of people. This refugee crisis is a global human rights crisis.

The prominence given to policing the movement of people between borders is an indication that nation states are asserting their territorial sovereignty in the face of the free movement of capital, goods and services brought about by globalisation. Baker states that human trafficking “is the fastest growing form of cross-border crime and the ugliest aspect of globalization.”\textsuperscript{1122} Baker holds that globalisation facilitates cross border criminal activity because “the ease with which money is shifted among groups, laundered across borders, and transferred into the legitimate financial system is the primary facilitating mechanism that make such (cross border crime) operations so successful.”\textsuperscript{1123}

One impact of globalisation is that nations have been reduced to being able to ‘guard’ or maintain their sovereignty almost exclusively by way of border controls over the movement of people while at the same time the movement of capital across borders is unfettered across most national borders. As was seen in chapter 6 this unfettered movement of capital makes transfer pricing possible and national tax authorities are unable to effectively prevent corporations from profit and tax shifting by the use of transfer pricing. This makes the reported profitability of transnational corporations a voluntary exercise by corporations of where they wish to declare their profits, if any, and therefore where they wish to pay company tax.

\textsuperscript{1122} Baker RW, \textit{Capitalism’s Achilles Heel: Dirty money and how to renew the free-market system,} as above, p100
\textsuperscript{1123} Ibid
As Owens, the Head of Fiscal Foreign Affairs Division of the OECD states, “overall the mechanisms for international co-ordination of economic policies remains weak. No where is this more evident than in the tax area.”

Owens has identified the problems created by the weak economic co-ordination in the tax area as:

The base for taxes and income and wealth will become more geographically mobile and therefore more sensitive to tax differentials. This, in turn, will lead to a greater danger of tax competition between countries, with each country trying to attract a larger share of the global tax base.

It will become more difficult to determine and to collect taxes on activities which take place outside a countries’ tax jurisdiction. This is not just a question of the volume of cross-border transactions increasing, but of their changing nature.

Owens goes on to suggest that the “ways in which tax administrations carry out their ‘business’ will change. New technologies open up new ways of assessing and collecting taxes, and for co-operation between tax authorities in different countries.”

Funding of human rights in a globalised world needs to recognise the imbalance between corporate power and needs and people power and needs. Nations need to be able to fund the policing of this cross border criminal activity of human trafficking. In other words nations need sufficient funds to provide for negative human rights, such as physical protection, as examined in the first chapter. As well, nations need funding to provide for the positive human rights for the people in their jurisdiction whether these people are citizens or refugees because all people need food, clothing, shelter, access to health and education. Nations need to find ways of taxing corporations so that there is some connection between corporate activities in a jurisdiction and the taxes paid by the corporation. Profit shifting has to be stopped to ensure corporations are ‘bound’ to a jurisdiction in a similar way that people are ‘bound’ to a jurisdiction.

1124 Ibid, p22
1125 Ibid, p23
1126 Ibid
Globalisation and Sovereignty

EU scholars have been grappling with the theories of sovereignty in the post-EU world for some time. It is a useful exercise to see where these scholars have taken the notion of sovereignty in the post-Westphalian era and see how it can be applied to the globalised world order. As demonstrated in chapter 6 corporations do earn profits worldwide, shift profits by the use of transfer pricing and therefore shift tax payable into favourable tax jurisdictions. In order for nations to effectively tax TNCs, nations have to make a claim to sovereignty as the authority to impose that taxation.

Sovereignty, in the final analysis is about a plausible and reasonably effective claim to ultimate authority, or in perspective theory a representation of authority made on behalf of a society which is (more or less successfully) constitutive of that society as a political society, or as a polity. Sovereignty claims, when they achieve some measure of acceptance, continue to have profound political and social effects, and have to be taken seriously at the explanatory level for that reason.1127

In order to tax TNCs, nations must begin to work beyond their national institutions and national authority in the same way the TNCs operate beyond national boundaries. Different approaches must be found to impose authority outside the normal national taxing jurisdictions.

Walker uses the term ‘late sovereignty’ to denote the phase we are in and calls late sovereignty, that is, the current times, a time, in terms of sovereignty of “continuity, distinctiveness, irreversibility and transformative potential”1128. Walker explains the terms he uses to define our current times as:

1. Continuity

Late sovereignty continuity, in Walkers’ terms, allows a late sovereign polity such as the EU “like the state polities of early sovereignty, (to) still makes the claim of ultimate authority and, like these state polities, does so through a complex of institutions which, however and wherever derived, comes to claim to be representative of the polity in question.”1129

1128 Ibid, p19
1129 Ibid, p21
2. Distinctiveness

“Sovereignty is always a claim over a particular society … a claim to constitute that society as a polity or political community, as it always necessarily excludes as well as includes.”¹¹³⁰ Late sovereignty distinctiveness recognises that sovereign claims to authority are no longer “merely territorial, but … also functional”¹¹³¹. Walker believes that in this post Westphalian era, even though the “boundaries between different polities are still deeply contested”¹¹³² assertions of legitimate authority will overlap and intersect and become more systematic.

3. Irreversibility

Walker holds that late sovereignty is irreversible because “the dynamic of globalisation, and of the responses to globalisation through the formation of non-state polities, continues inexorably to unfold. The challenge of multinational capital, of global communications and of free movement of goods, services, persons and capital is beyond the regulatory grasp of the state, and the grant of regulatory authority to non-state polities (as happens in the EU, NATO, ASEAN and other supranational bodies) consolidates and reinforces that process.”¹¹³³ The development of non-state polities cannot be seen as a “holding measure until states reassert their hegemony, but rather as a process of reallocation of regulatory authority which guarantees that states will never re-establish that hegemony.”¹¹³⁴

4. Transformative

The transformative potential of late sovereignty poses challenges and offers the capacity “to consider, balance and co-ordinate the various public goods and private interests”¹¹³⁵ in our globalised environment. The challenge is to maintain the core of sovereignty, which is that “a sovereign order must assume its own continuing or self-amending sovereignty within its sphere of authority (rules of recognition and change) and must retain interpretive autonomy (rules of adjudication), deciding the boundaries of that sphere of authority.”¹¹³⁶ The capacity of late sovereignty is its ability to deal with what Walker calls ’sovereign sites’. Sovereign sites encompass both the territorial and normative reach of sovereignty. Late sovereignty can

¹¹³⁰ Ibid, pp21 and 22
¹¹³¹ Ibid, p22
¹¹³² Ibid, p23
¹¹³³ Ibid, p24
¹¹³⁴ Ibid
¹¹³⁵ Ibid, p32
¹¹³⁶ Ibid, p 29
deal with the “novel, complex and untidy legal arrangements for the development of ‘constitutional’ relations between sovereign sites we can see the development of a dynamic in which actors with partial and interconnected governance projects in the same policy sectors can begin to imagine and reciprocally enact and co-ordinate polity-transcending comprehensive governance projects.”

The challenges of late sovereignty are to maintain the legitimacy of the reach of power beyond territory and the legitimacy of the policing of this extended reach of power.

Finding ways to fairly tax the profits of corporations so as to do justice is complex and difficult. Add in the fact that most major corporations earn profits globally; trying to fairly allocate those profits and the associated tax liabilities globally are even more difficult. John Stuart Mill who, while recognising the difficulty of ‘doing perfect justice in taxation’ held that “the difficulty of doing perfect justice is no reason against doing as much as we can.”

The difficulties faced by national taxing authorities in attempting to tax transnational corporations (that is corporations operating globally) are some of the challenges of late sovereignty.

**Summary of Main Thesis Argument**

The first three chapters of this thesis examine the justice of taxing companies and how that justice might be achieved. Taxation is a human rights issue because without adequate taxation revenues nation states cannot safeguard negative rights or provide positive rights for their populations. Avoiding or evading taxation then becomes a matter of human rights abuse, not a moral matter.

Chapter four is a critical history of the notion of limited liability. Limited liability gives the owners of large companies the advantage of being able to avoid the negative consequences of the acts of their company at no cost because they are able to ‘externalise’ the costs of their companies’ actions. They do this by leaving environmental damage, product liability, unpaid workers and creditors in the event of liquidation. These costs are then taken up by those damaged by the corporation or the society in which the corporation has left the damages. The owners of small companies, because of their size, tend to bear the cost of their companies’ activities by being required to give personal guarantees and being liable for their own torts.

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1137 Ibid, p30
This leads to the conclusion that the shareholders of large companies should be treated, for tax purposes, differently from small companies by being their shareholders being denied the benefit of dividend imputation. The reality of small companies should be acknowledged and, for the purposes of tax, the corporate veil stripped away so that the owners of small companies are taxed as partnerships as is done in the United States (examined in chapter eight).

Chapter five examines the issue of corporate welfare and the competition between the Australian States and between nation states to hand out corporate welfare. This competition to hand out welfare was found by the Australian Industry Commission to ‘at best shuffle jobs between regions and at worst reduce overall activity.’

Chapter six examines corporate tax avoidance by the use of transfer pricing used to shift corporate profits between taxing jurisdictions. This leads to the conclusion that corporations must be taxed globally in order to fairly apportion the income taxes of a corporation between jurisdictions in which the corporation operates. The formula apportionment method of allocating profits between jurisdictions was examined in chapter eight where the experience of formula apportionment in Canada and the United States was examined.

**Taxation Reform Proposals**

This thesis has identified three major areas of favourable taxation treatment of Australian corporations, as compared to the taxation treatment of people, by Australian governments. These are

- Dividend imputation
- Corporate welfare
- Transfer pricing.

The first two issues can be dealt with on a national level. Transfer pricing needs to be addressed globally.

**National Taxation of Corporations**

In Australia the national taxing authority can address one of the major inequities in the taxation of Australian corporations, that is, the inequity of dividend imputation. The Australian governments, State and Federal, can also address another major inequity in the tax

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treatment of corporations, that is, in the allocation of transfer payments to selective corporations by way of corporate welfare.

**Dividend Imputation**

As was seen earlier, dividend imputation lifts the corporate veil from corporate profits. Dividend imputation means that Australian shareholders who receive dividends paid out of company earnings on which company tax has been paid receive a credit for that tax. In doing this dividend imputation ignores

- the collective advantages shareholders have as a group of investors ‘pooling’ capital,
- the advantages shareholders have of limited liability, and
- the separate legal personhood of the corporation.

In order to address the inequity caused by dividend imputation Australian taxation authorities should, as is done in the US make a distinction between large and small corporations and the way they are taxed. The US recognises that major corporations do have a distinct legal personality from their shareholder and do not apply dividend imputation. The US also recognises that smaller corporations are not legally distinct from their ‘owners’ and so no tax is applied to these companies. In the case of the small corporation the corporate veil is moved aside and the financial activities of the corporation, sales, expenses, profits and losses are allocated to the shareholders who are taxed accordingly.

**Corporate Welfare**

Corporate welfare payments are considered as transfer payments of taxation revenue to corporations. Corporate welfare is inequitable as between corporations because of the selective way corporate welfare is handed out. Corporate welfare is also seen as inefficient because, just as with global tax competition, “such tax competition is likely to result in some misallocation of the world’s capital and reduced global output.” In Australia, the Tasmanian Chamber of Commerce and Industry talking about government competition to hand out corporate welfare stated that “When governments compete over financial and other incentives to attract business (particularly tax holidays) then the competition becomes destructive and inefficient.

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1140 Nygh PE and Butt P (Eds), *Butterworths Australian Legal Dictionary*, as above, p376
1141 Preston A, ‘Taxation policy and Australia’s competitiveness’, as above, p24
1142 An industry lobby group
The government provision of selective corporate welfare should be eliminated. As an alternative, in order to address the unfair treatment of corporations in the way corporate welfare is paid in Australia and to redress the economic inefficiencies of corporate welfare governments should set the scene for economic development by providing

- “Efficient user-friendly infrastructure such as education, roads, ports and waste management and operating these in an efficient low-cost way;
- Simple, stable and transparent institutional rules which facilitate interactions and lower transaction costs of doing business, by establishing user-friendly laws and regulations, and enforcing them convincingly”.

This list of items of appropriate government spending which assists industry also makes for a stable society for the humans living in it.

**Global Taxation of Corporations**

There needs to be an alignment of corporate profits and taxation to the jurisdictions in which corporations actually earn the profits. The US formula apportionment method of allocating profits between jurisdictions is based on sales made, property owned and people employed in a particular jurisdiction. This apportionment recognises the physical impact of corporations in a jurisdiction and attempts to apportion profits recognising this impact. The apportionment is not perfect but at least it recognises some of the reality of the operation of a corporation. The formula could be improved by recognising the impact that corporations in jurisdictions have on the external environment, for example, the carbon emissions made by a corporation in each location. Profit apportionment formulas should be continually refined over time to incorporate the cost of hitherto externalities such as air and water pollution, cost to infrastructure, costs to the health of local populations caused by pollution and congestion.

Apportioning corporate profits grounded in a physical reality, even if not perfect, recognises the impact corporations, artificial people, have on real people where they physically live and work.

National taxing authorities applying transfer pricing rules in an attempt to apportion corporate profits based on a notion of ‘arms length’ dealings. As transnational corporations grow larger and control ever greater levels of world trade finding ‘arms length’ values for trade becomes more difficult. By 1998 it was found that

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Today, the global corporate market is indeed ‘monopolistic in tendency’. The largest 300 corporations, for example, control 98% of all foreign direct investment, and 60 per cent of all land cultivated for export.\textsuperscript{1145}

The ATO recognises the difficulty of trying to find comparable arm’s length transactions in order to determine a ‘market price’ for intercompany transactions and acknowledges that competitive free markets no longer exist for many intercompany transactions. The Australian Taxation Ruling TR 97/20 ‘Income tax: arm’s length transfer pricing methodologies for international dealings’, details profit methods that can be applied to intercompany dealings and the guiding principle in applying these methods is to apply a method “that makes commercial sense in the circumstances of the case.”\textsuperscript{1146} This vague guideline for apportioning profits between companies in a group of companies needs to be replaced with a more transparent method of allocating profits. Profits should not be allocated between companies in a group but all of a group’s profits should be consolidated using international accounting standards. These consolidated profits should then be allocated to between taxing jurisdictions based on a formula that recognises the jurisdiction where the profits were earned using the US formula as a starting point. That is, using the transparent indicators of sales, people and property. Corporations would then be confident that profits were only taxed once and taxing authorities would be confident that all profits were being taxed, albeit in different jurisdictions.

Advantages of formula apportionment;

- Transparent
- Relatively simple to apply, especially when compared to transfer pricing
- Nation states retain autonomy over taxation revenues
- Formula open to refinement to take account of externalities, eg carbon emissions

Formula apportionment will not prevent corporations from understating their worldwide profits and illegally siphoning funds into tax havens. Auditing of corporations should be able to moderate profit misstatement. The illegal siphoning of funds into tax havens will be a continuous challenge for tax enforcement authorities.


\textsuperscript{1146} TR97/20, para 3.55
The value of the various factors making up the formula would be different between countries and this difference would be reflected in the allocation of profits between countries. For example, the value of sales, the cost of labour and property would be higher in Australia than it would be in Bangladesh. Formula apportionment would maintain these differences when the formula is applied to distribute profits.

The challenge for implementing formula apportionment is the challenge for sovereign states to establish and “rethink international global institutional arrangements in democratic terms”\(^{1147}\). Patomaki and Teivainen were referring to the challenge of establishing a supranational Currency Transactions Tax Organisation (‘CTTO’). Patomaki and Teivainen argued that a currency transactions tax (‘CTT’) would improve the ability of nation states to impose democratic policies by “curbing the unnecessary and undesirable power of transnational financial flows, the CTT would ease the grip of finance over democratic politics.”\(^{1148}\)

This thesis argues that corporations’ profits allocated between taxing jurisdictions, and then taxed by those jurisdictions, so that the allocation reflects the physical presence of the corporation in a jurisdiction will also improve the ability of nation states to impose democratic policies. The CTTO proposed by Patomaki and Teivainen would allocate tax revenue raised to global needs. The global body to determine and impose the formula apportionment of corporate profits would be limited to establishing and continually refining an appropriate formula using a “fair, transparent and accountable process”\(^{1149}\) as envisaged for the CTTO. The sovereign nation states would raise the corporate taxes in their jurisdiction applying the internationally agreed formula. Nations would so retain sovereignty over corporate tax revenue while a global taxing authority would administer and apply the global formula for apportioning corporate profits between taxing jurisdictions. The organising principles of the new organisation would need to be established, as proposed for the CTTO, combining “state representation with parliamentary and civil society representation.”\(^{1150}\)

Australia is a first world economy with a federal taxing authority that is held in regard by society for its lack of corruption. Australian taxation authorities are however, as was seen earlier, unable to prevent transfer pricing by TNCs operating in Australia. The ATO also

\(^{1147}\) Patomaki H and Teivainen T, *A Possible World: Democratic Transformation of Global Institutions*, as above, p174

\(^{1148}\) Ibid, p168

\(^{1149}\) Ibid, p169

\(^{1150}\) Ibid, p175
lacks the resources to conduct more than random audits of transfer pricing activities by corporations in Australia. The need for a corporate profit allocation to be globally regulated and administered is evident in first world countries like Australia. However, the need is even greater in developing nations, as is illustrated by the following example.

The Big Australian

BHP Billiton (‘BHP’), formerly BHP Limited, was for many years Australia’s largest public company and affectionately known to Australians as ‘the big Australian’. BHP is now Australia’s second largest and the world’s 97th largest company. The big Australian had a reputation as a socially responsible company which has been tarnished by the results of its open cut copper mining venture in Australia’s near northern neighbour, Papua New Guinea. BHP was a major shareholder in Ok Tedi Mining Limited (‘OTML’) from 1981 when mining leases were granted to 2002 when BHP withdrew from the mine.

In 1984 mining commenced at the Ok Tedi mine in Papua New Guinea. It was supposed to be a project that would bring benefit and prosperity for all concerned.

The mine, however, proved to be “nothing short of an environmental, social and financial disaster.” The operations of the mine have dumped, and continue to dump, 80 million tonnes of waste rock into the Ok Tedi River annually. The damage caused by this has been “loss of forests and crops to flooding”. The damage has been reported as 500 square kilometres of forest die back which is expected to increase to at least 1,350 square kilometres, a fall in fish numbers in the Ok Tedi river by 90%, copper levels in the river are up to 30 times their natural level and predictions of highly toxic forms of copper poisoning in the river. The local rural population are mainly “subsistence farmers who depend on a healthy natural environment for their very survival.” The mine has turned out to be a human rights disaster for this local population.
BHP acknowledged the damage caused by the mine and in January 2002 transferred its 52% holding in the mine to the PNG Sustainable Development Program Limited. That was it, BHP was able to “walk away with specially legislated indemnity knowing that this great tropical river system and the people whose lives depend on it face ongoing massive damage”\(^{1159}\).

Ironically, is that the new majority shareholder PNG Sustainable Development Program Limited relies on its dividend income from the environmentally damaging mine to invest in sustainable development projects in the region. “Two thirds of these dividends will be invested for future generations until after the mine closes.”\(^{1160}\) The mine, still polluting the environment, is planned to close at the end of 2012. The pollution and the income from the mine will then cease to flow. However, unlike the income, the effects of the pollution are expected to continue many years into the future. According to OTML, the forests are expected to take around 200 years to recover after the mine closure\(^{1161}\). According to the Australian Conservation Foundation over time “acid rock drainage… could mobilise highly toxic forms of copper poisoning the river. Very few, if any, mining operations around the world have dealt successfully with the scale of this risk.”\(^{1162}\) Long after income from the mine has ceased to flow, the effects of the pollution caused by the mine will need to be paid for.

No financial details are available covering the period when BHP was an owner of OTML. However, the OTML ‘Key Statistics’ do reveal that the shareholders of Ok Tedi paid themselves their first dividends from 1991. Tax, however was not paid to the PNG government until 1995, four years after dividend were paid and one year after local landowners sued the mine and BHP in the Victorian Supreme Court for environmental damage.\(^{1163}\)

The OTML experience has been a disaster for the local population and yet it promised prosperity. Chang and Grabel in their book, *Reclaiming Development*\(^{1164}\), reject the neoliberal view that foreign direct investment of the kind made by OTML is “beneficial to developing countries”\(^{1165}\) because foreign direct investment “and other TNC activities have

\(^{1159}\) Ibid

\(^{1160}\) OK Tedi Mining, ‘About Us – Key Statistics’, as above

\(^{1161}\) Ibid

\(^{1162}\) Henry D, ‘Leaving the scene of the mine’, as above

\(^{1163}\) OK Tedi Mining, ‘About Us – Key Statistics’, as above


\(^{1165}\) Ibid, p135
been associated with numerous problems in the developing world. These problems have not disappeared.”1166

Chang and Grabel listed four problems experienced by the developing world as;

1. “TNCs transferred obsolete and ‘inappropriate technology to developing countries often at inflated prices.”1167

OTML reports that before mining production began in 1984 “massive landslides destroy the foundations of the OK Ma tailings dam during construction. Mine tailings can no longer be stored.”1168 Despite this, mining commenced and the tailing merely dumped into the OK Tedi River. The levels of environmental damage that the operation of the OTML mine produced from the very first day of operation would have been unacceptable in a first world country like Australia.

2. “TNCs exercised enormous monopoly power over political and economic conditions within host economies.”1169

OTML reports that in 2004 the company’s export sales “represented 25.7 per cent of PNG’s export earnings.”1170 The importance of this one operation to the economy of PNG may have been a factor in the PNG government giving BHP a complete indemnity for the damage caused by the operation of the mine.

3. “TNCs evaded taxes by engaging in the practice of ‘transfer pricing’.”1171

There is no way of determining whether or not OTML evaded taxes due to the PNG government by the use of transfer pricing. What is unusual is that OTML paid preference dividends in 1991, four years before the company paid any taxation.

4. “TNCs discouraged domestic investment because local firms could not compete with foreign firms.”1172

1166 Ibid, p 138
1167 Ibid
1168 OK Tedi Mining, ‘About Us – History of Development’, as above
1169 Chang H-J and Grabel I, Reclaiming Development, as above, p138
1171 Ibid
1172 Ibid
There is no way of determining whether or not the operations of OTML discouraged domestic investment in PNG.

Chang and Grabel recognise that “developing countries confront serious problems with the collection of corporate, income and property taxes at federal and local levels.” 1173 This must be done, they continue, by tax reform that focuses on reducing tax evasion. 1174 They suggest that the best way of accomplishing better tax administration is “by the creation of politically independent fiscal authorities.” 1175

Globally administered formula apportionment of corporate profits would necessitate the formation of a politically independent fiscal authority of the kind suggested by Chang and Grabel. Globally administered formula apportionment of corporate profits would require nation states in this period of late sovereignty to endorse the ‘process of reallocation of regulatory authority’ and recognise that in our globalised world ‘assertions of legitimate authority will overlap and intersect and become more systematic’. This process of asserting global control over the allocation of the global profits of corporations is merely one step towards recognising late sovereignty.

1173 Ibid, p189
1174 Ibid, p190
1175 Ibid
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1176 Tax Office rulings are numbered by their year of release, followed by the number representing the chronological release for the year. TR94/14 is therefore, the 14th ruling released in 1994. Taxation rulings have the force of law if released after 1997. Before 1997 tax rulings only represent the views of the ATO.
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Appendices
Appendix A

Corporations as Rightholders

Corporations in Australia are legal persons with the same rights and obligation as human persons. Korten in *The Post-Corporate World*\footnote{Korten DC, *The Post-Corporate World*, a co-publication of Kumarian Press, Inc. and Berrett-Koehler Publishers, Inc., United States of America, 1998} recognises that “human rights secure our freedom to live fully and responsibly within life’s community.”\footnote{Ibid, p183} Korten holds “that as corporations have become increasingly successful in claiming these same rights for themselves, they have become increasingly assertive in denying them to living people.”\footnote{Ibid} In Australian law the corporation is recognised as a person with rights and obligations and generally treated as a legal person. Only in the area of criminal law may the ‘fiction’ of the corporate person be ignored and sometimes the persons responsible for the criminal actions held to account.

Theories of Corporations

There are four major legal theories of corporations, the concession/fiction theory, the bracket theory, the contract-nexus theory and the realist and natural entity theory.

1. The concession/fiction theory holds that “the state has the power to bestow legal personhood on anything it desires; and, when it is done, the creation – which is an artifice – in law is a real live person.”\footnote{Glasbeek H, *Wealth by Stealth: Corporate Crime, Corporate Law, and the Perversion of Democracy*, published by Between the Lines, Toronto, Canada, 2002, p287}

2. The bracket theory holds “that a corporation is but a legal envelope, or a set of brackets, for the live human beings who have decided to conduct profit-seeking activities in a collaborative manner.”\footnote{Ibid} Because this theory assumes that when seeking to allocate responsibility for corporate actions the brackets can be swept aside to reveal the persons behind the actions “it negates the very purpose of the creation of a separate property holding entity and flies directly in the face of how corporate law works.”\footnote{Ibid, p288} The ‘very
purpose’ of creating a company being to protect persons from liability arising from their actions.

3. The contract-nexus theory holds that a corporation is a scheme of contracts used to aggregate individual investors and that the rules of incorporation exist to “facilitate such contracting”\(^\text{1183}\). Supporters of this theory believe that the contracts between the shareholders, which create rights between shareholders, are not the business of the state.

4. The realist and natural entity theory holds “that the corporation is an organic whole, one that transcends the mere aggregation of its component parts and people. It is a thing in its own right, to which responsibilities should be attached directly. It is not a fiction in any sense. It has a life and culture that are its very own and not a reflection of those who – necessarily – must act on its behalf.”\(^\text{1184}\)

The Australian Legal Approach to Corporations

The concession/fiction theory of corporations has been adopted in Australia in relation to taxation law. Australian criminal law has adopted elements of the bracket theory and the realist theory. As well, Australian law only recognises corporations as individual entities, that is, the law does not recognise groups of companies as intrinsically linked. In *Walker v Wimbourne*\(^\text{1185}\) the High Court emphatically rejected the notion that a group of companies could be treated as a single entity. Mason J held that even though an individual company may be a member of a group of companies, and gain financial benefits from membership of the group, this must not obscure the fundamental principle that each company is “a separate and independent legal entity.”\(^\text{1186}\) This approach allows companies, in groups of companies, to minimise tax by moving expenses between members of the group in order to minimise an individual company’s tax liability.

As a result of the Review of Business Taxation,\(^\text{1187}\) (“Ralph Review”) completed in 1999, the *Income Tax Assessment Act 1997* (“ITAA97”) now includes provision, in Division 700 of the Act, for groups of companies to be treated as a single consolidated entity for taxation purposes. The first general principle for consolidation included in the Ralph Review was that “consolidation is optional, but if a group decides to consolidate, all its wholly owned

\(^{1183}\) Ibid

\(^{1184}\) Ibid

\(^{1185}\) (1976) 137 CLR 1

\(^{1186}\) *Walker v Wimbourne* (1976) 137 CLR 1, Mason J at 3

Australian resident group entities must consolidate\textsuperscript{1188}. In the ITAA97 this has been taken up in s700-1 as follows,

This Part allows certain groups of entities to be treated as single entities for income tax purposes.

Following a choice to consolidate, subsidiary members are treated as part of the head company of the group rather than as separate income tax entities.

The entity approach has not been killed off by the legislative changes; rather, group companies can now choose how they are taxed. The legislative approach has been modified to allow companies in a group to determine whether they consolidate for tax purposes or maintain the traditional entity approach to taxation.

Corporations are not a physical or corporeal being, that is, they cannot be imprisoned, they are not sentient, feeling, thinking beings, they have no physical needs to be satisfied and they do not vote. However, corporations can injure and kill people, they can decide where to establish their operations, how many people they will employ, how much waste their production will produce, etc. and they can influence the outcome of elections and government decisions by lobbying government and making political donations.

Australian law recognises corporations as having a separate legal existence and this recognition gives corporations the same legal rights as humans. However, corporations do have advantages over humans in that they have been granted legal personhood yet have no corporeal existence, and their shareholders obtain the benefit of limited liability.

The legal recognition of the corporation also confers the same legal obligations on corporations as on humans. However, the essential and most important difference in the treatment between corporations and persons is in the sanctions that can be imposed for failing to meet those legal obligations. Persons can be sent to gaol and have financial sanctions imposed. If a person can’t meet their financial obligations the legal sanctions often mandate a period of detention in gaol. The only sanction that can be imposed on a corporation is a financial sanction. If the corporation can’t meet its financial obligation it merely winds up. Limited liability allows the shareholders the ability to establish another corporation and continue in business.

\textsuperscript{1188} Ibid, p517
Governments have the responsibility uphold human rights in their jurisdictions. To do this, governments need to raise revenue from their rightholders, that is, from persons and corporations. Corporations have been given rights additional to those given to persons and therefore have a corresponding obligation to pay for those rights through taxation.
Appendix B

Stock Market Participation in Australia

An Australian Stock Exchange (‘ASX’) study of share investors in 2004 revealed that, “55% of the Australian adult population, or approximately eight million people, owned shares directly or indirectly (via a managed fund or self-managed superannuation fund). … Of the population, 44% or about 6.4 million, held shares directly.” 1189

The study found that, in 2004:

1. Gender influences share ownership with 50% of males and 40% of females owning shares. 1190
2. The older one gets the more likely one is to own shares. 55% of over 55’s, 35% of those aged 25 to 34 and 21% of those aged 18 to 24 own shares. 1191
3. The higher the level of education the higher the level of direct share ownership with 56% of postgraduates compared to 39% of those with year 12 education owning shares. 1192
4. Household income influences share ownership with 68% of people with household incomes over $100,000 per annum and 39% of people with household income of $30,000 to $40,000 per annum owning shares. 1193
5. Direct ownership of shares is just as likely in regional Australia as it is in the main cities. 1194
6. The average number of companies held in a share portfolio was six with 74% of investors holding shares in three or fewer companies. 1195
7. The average value of direct investment in shares was $41,400. 1196
8. The average number of trades was seven with an average value per trade of $11,150. 1197

1190 Ibid, p29
1191 Ibid
1192 Ibid, p30
1193 Ibid
1194 Ibid, p32
1195 Ibid, p33
1196 Ibid
1197 Ibid
International comparisons of share ownership reveal that Australia has “one of the highest penetrations of share ownership among its population when compared to other nations.”\textsuperscript{1198}

An international comparison of direct and indirect share ownership in the year 2002\textsuperscript{1199}

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*Share ownership in the year 2001 as 2002 figures not available, this had fallen to 37% in 2003.

\textsuperscript{1198} Ibid, p41
\textsuperscript{1199} Ibid