

# A Counter-Cyclical Tax Reform

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## Executive Summary

With the present brief we wanted, in the first place, to argue that business cycles are, to a certain extent, unavoidable, though they can be moderated; as a consequence of profit expectations and because of the role played by financial markets, capitalist economies develop by facing oscillations.

In dealing with such waves, an institutional approach should be preferred. Among the institutional reforms to be implemented with counter-cyclical purposes, we suggest a tax reform for Malaysia resting on three pillars:

- a reformed and reduced income tax, aiming to support the economy and to balance the increase in indirect taxation proposed with GST and CGT;
- a progressive GST replacing the existing and controversial SST;
- a progressive capital gain tax, inspired by the model proposed by Hanusch and Wackermann (2011).

We believe that the scheme presented here would present the following advantages:

- it is not distortionary, and it should not generate negative incentives discouraging economic activity;
- it nudges in favour of a saving-oriented mentality, intended as the necessary drive for sustainably financed investments;
- it would help keep the investment pace away both from overheating and depressing.

Such a reform has a chance to achieve its targets only if is accompanied by fiscal discipline and by rationing public expenditures, paired with a growing effort toward accountability.

## I. Business cycles are unavoidable



Cyclical waves are the reality of economic development in a capitalistic system. This means that capitalism without fluctuations does not exist.<sup>1</sup> Cowen and Tabarrok (2015, p. 8), in their economics textbook, stressed the importance of economic fluctuations by mentioning them as one of the big ideas in economics: “Big Idea Eight: Economic Booms and Busts Cannot Be Avoided but Can Be Moderated”, adding that «booms and busts are part of the normal response of the economy to changing economic conditions».

The key elements in our approach to business cycles are profit expectations, which are at the very root of any investment decision, and financial markets. Expectations are what guide people's actions. A boom is generally initiated

when entrepreneurs see unexploited profit opportunities and take advantage of them, i.e. they have positive expectations, or, otherwise, they are future-oriented and ready to make the production process more roundabout.

Such a situation encourages the onset of major investments in production assets, or capital goods, whereby the economy becomes, in general, more capital-intensive, i.e. the production period is extended (Hayek, 1931, pp. 35-36). However, even if entrepreneurs become more future-oriented, such a change does not necessarily bring with it a modification of preferences on the consumer side, and we encounter a difference between entrepreneurial decisions and consumer choices (Hayek, 1933, pp. 143-148). This situation opens the door to the frustration of the expectations of one of the two groups (Lachmann, 1943, p. 69 and Hayek, 1933, p. 145).

In this scenario, as consumers are not necessarily saving more in order to finance new investment decisions, entrepreneurs need to resort to their own financial resources or, as is usually the case, to a general expansion of the capital supply from the credit system, which thus becomes crucial in supporting an emerging boom. Financial markets, in fact, are not immune from the positive sentiment created by a growing wave of entrepreneurial activities. Most investments are made in the expectation that the supply of capital will continue for some time at a level consistent with the new demand for loanable funds. In other words, entrepreneurs regard the present supply of capital and the present rate of interest as a symptom that approximately the same situation will continue to exist for some time (Hayek, 1933, p. 142).

While entrepreneurs invest in new processes for the production of capital goods, savers are frustrated in their desire to consume, because what they want is not being produced. A forced saving phenomenon thereby develops; as a consequence of the fact that production resources were diverted from sectors close to consumers, there is a gradual reduction in the production of consumer goods and therefore an involuntary limitation of consumption (Hayek, 1933, pp. 145-146).

<sup>1</sup> This is what is argued in Ferlito (2014 and 2016, Chapter 3) with the doctrine of the *natural cycle*. There a comprehensive list of economists supporting the same conclusion can be found.

The entrepreneurial impetus towards new investments, on the other hand, initially involves an increase in raw material prices and consequently of the capital goods produced with them. The impetus becomes particularly forceful when the wave of the first innovative entrepreneurs is joined by the pressure of imitators, who grasp profit opportunities only in a second stage and attempt to benefit by following the trend and are driven by rising return expectations. On a closer look, imitative speculative waves are typical of every boom stage described in history. The secondary stage is thus characterized by the appearance on the market of an exceptional number of imitators, driven by profit expectations arising from observing the ongoing boom set in motion by the first innovative entrepreneurs (Schumpeter, 1939).

At the same time, demand for labour increases and is drawn towards the new investments, with a relative increase in wages: this in turn encourages demand for consumer goods, and prices in that sector also increase. It is therefore evident that the increase in non-monetary income will not be matched by an increase in real incomes because of the inflationary effect exerted by unsatisfied demand for consumer goods.

In order to be sustained, this process requires credit expansion without respite – which would bring about a cumulative increase in prices that sooner or later would exceed every limit. The conflict becomes evident when demand for consumer goods exceeds the funds available for investment in terms of absolute value. At this point, the interest rate cannot but rise, frustrating demand for capital goods precisely when their prices have also risen. A considerable part of the new plant installed, designed to produce other capital goods, remains unused since the investments required to complete production processes cannot be made (Hayek, 1933, p. 148). As a result, in an advanced stage of the boom, growth in demand for consumer goods brings down demand for capital goods (Hayek, 1939, p. 31).

At the peak of the boom, the economy discovers that it is unable to sustain production oriented over and above its possibilities. Demand for capital goods runs out, taking with it the over-production in the particular sector where the boom started, and it is here that problems arise. Many economic initiatives set up through excessive reliance on profit expectations, on speculation fever or on credit cannot be completed, although the debts still must be paid. Many companies are driven out of the system. Capital becomes scarce, and banks raise interest rates. A period of adjustment and return to equilibrium begins, although it has the appearance of a depression.

## 2. A counter-cyclical tax reform for Malaysia

As mentioned at the beginning of the paper, business cycles cannot be avoided but can be moderated. Every recession presents its own peculiarity and it is therefore difficult to design universally valid counter-cyclical measures: macroeconomics, with its aggregative methodology, presents more limitations than advantages when designing policies (Garrison, 1992). Policymaking requires humility as the economic system is a dynamically ever-changing organism. The unintended consequences of over-ambitious policies can be dramatic and worse than the disease itself.

Experience from both fiscal and monetary policy shows how difficult is to tackle a recession with pre-designed and overly general stimulus packages, which can be more harmful than beneficial (Ferlito, 2013, Chapter 3 and 4). As an example, post-2008 ECB quantitative easing results are, at best, non-uniform and controversial. Instead, as suggested in Kates (2017, pp. 380-381), lowering taxes, rather than increasing taxation, fiscal balance and avoiding new debt are better solutions for a sustainable and long-run recovery.

The attempt presented here to design a counter-cyclical tax reform for Malaysia should be seen as a series of suggestions featuring the following objectives:

- be the least distortionary and discouraging as possible for economic activity;
- nudge in favour of a saving-oriented mentality;
- keep the investment pace from both overheating and depressing.

The proposal, thus, does not aim to prevent fluctuations but to contain them without, at the same time, depressing the system of incentives which governs economic dynamism.

### 2.1 Adjusting the income tax

Because of the new taxes proposed with points 2.2 and 2.3, it is necessary to adjust the burden of direct income taxation, as merely adding fiscal burdens will disincentivize economic activity and thus have a depressing effect. In fact, the need for the government to improve its revenues would be frustrated if such an attempt were perceived as a limitation to economic activity; as suggested by the Laffer curve (Varian, 2010, p. 288), «when the tax rate is high enough, an increase in the tax rate will end up reducing the revenues collected. The reduction in the supply of the good due to the increase in the tax rate can be so large that tax revenue actually decreases».

We propose here to lower income tax, both on individuals and corporations. The reform should be a combination of modified rates and higher exemption thresholds for the lower income groups. We suggest that for the actual details the government should engage with the relevant stakeholders. The aim of the proposal is to help all income earners, in particular those from the lower groups, to cope with the new GST we propose below.

Following Garrison (1996), we must avoid developing a large system, because it would be the source of inefficiencies and complexities. We know that Malaysia struggles in enforcing tax collection; «the smaller the tax, the greater the prospects for simplicity and efficiency» (Garrison, 1996, p. 674).

A shift toward indirect taxation can help improve collection, but it must be accompanied by higher standards of enforcement – both for direct and indirect taxes – and by the reduction of unnecessary government expenditures, as suggested in Amirullah and Salman (2018, p. 8).

## 2.2 A progressive goods and services tax

The reduction of the income tax should be partially replaced by a consumption tax. With the Pakatan Harapan victory, the previous GST was abolished and replaced by SST. However, we believe that the way in which the GST was designed was more effective both in terms of implementation from the business side and of collection by the government. Moreover, being a fiscal credit for purchasers at each stage except the last one, it presented a lighter effect on final prices. Our proposal, therefore, goes in the direction of re-introducing GST but with some differences.<sup>2</sup>

From our perspective, the case for a consumption tax mainly lies in the possibility of stimulating saving. We have seen in the first part of this paper how the disproportionality between available saving and the demand for loanable funds is a key element in stimulating the creation of credit which supports an overheated boom and, therefore, opens the doors to an economic crisis. The presence of a higher amount of saving can, instead, support the demand for loanable funds coming from future-oriented investors. In the specific case of Malaysia, moreover, pro-saving nudging becomes particularly important due to the high level of household debt/GDP ratio, which is among the highest in the world.

A tax on consumption obviously leads to a modification of the structure of intertemporal preferences, thereby facilitating the creation of savings. The structure of preferences becomes more oriented towards the future, thereby generating resources for private investment thanks to increased savings, which, in turn, will signal to investors the availability of those resources at current prices (Garrison, 2001, pp. 102-103).

So, what may be seen is an increase in both savings (supply of loanable funds) and investments (demand for loanable funds), without having manipulated the rate of interest in any way whatsoever; in fact, the change of time preference is induced by the new tax system. Those entrepreneurs who respond to the signals by investing some of the real new available resources will generate a sustainable growth – sustainable precisely because grounded in saving rather than in virtual credit (Garrison, 2001, p. 104).

The key item, therefore, is not tax reform per se but the possibility of reducing consumption without changing the interest rate, while allowing a natural change in the structure of time preferences. Garrison (2001, p. 104) emphasized that «it is precisely the reduction of consumption that makes a higher growth rate possible». Such a perspective is completely opposite to the typical Keynesian argument according to which a recovery needs to stimulate aggregate demand. Here we claim that to resume growth, instead, it is necessary to stimulate investment by creating saving. In fact, «stimulating consumption during the transition by means of, say, a transfer expansion may be counter-productive. Again, if the net effect of the transitional dipping down and of the transfer expansion is actually to leave consumption spending unchanged, then the supposed beneficial effects of more rapid growth would be negated» (Garrison, 2001, p. 105).

<sup>2</sup> For some general but important inputs on a reformed SST or new GST, see Amirullah and Salman (2018).

Against this proposal it may be argued that taxing consumption could have a regressive effect, which means that the relative burden would be higher on the lower income citizens. This would be all the more true with regard to those basic goods which constitute the purchasing basket of the low-income population. Therefore, we suggest a progressive consumption tax; however, such progressivity should not be designed in such a way to frustrate productive initiatives and luxury consumption, which are key elements for economic growth. The unintended consequence of an overly progressive approach would be to discourage consumption behaviours which benefit the entire economic system; it should not be forgotten that to ‘punish’ certain types of consumption would affect the production of the goods involved, bringing harm to the relative value chain and its workers.

Our proposal is as follows:

- **Exempted goods:**

items related to the basic consumption habits of the lower-income population, such as rice;

- **Low rate GST (3%):**

key-development items such as culture and education related goods;

- **Middle rate GST (6%):**

all the goods not identifiable with the other three categories;

- **High rate GST (10%):**

luxury goods.

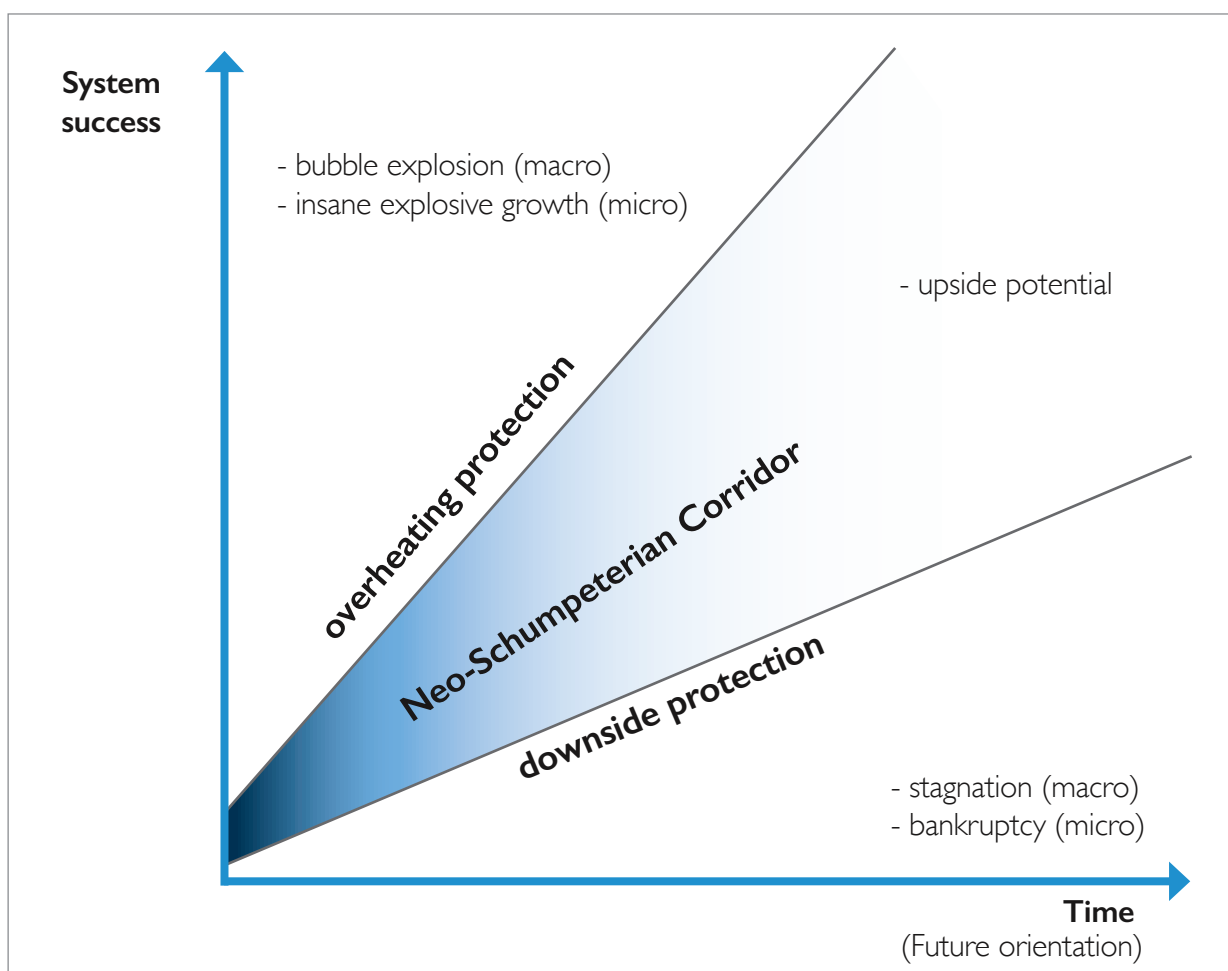
The rates indicated above should be intended as a suggestion, indicating the direction we believe to be beneficial; such a suggestion remains open for discussion.

### 2.3 A progressive capital gain tax

We would like to label this proposal as the ‘Hanusch-Wackermann tax’ (from now on HWT), because, as far as we are aware, it was proposed for the first time with anti-cyclical purposes in Hanusch and Wackermann (2011).

Hanusch and Wackermann (2011, pp. 61-62) described the economic system as an organic body in which development is brought in by the interaction of the three pillars that constitute this body: industry, finance and the public sector. Their proposal for a progressive capital gain tax is considered as part of the public sector role in supporting healthy growth of the economy, a role that «should be guided by a two-sided counter-cyclical strategy: on the one hand the concern to avoid trends of exaggerating or overheating in time and on the other hand the responsibility and effectiveness to overcome a possible period of stagnation as quickly as possible» (Hanusch and Wackermann, 2011, p. 63). The HWT, as we shall soon see, would help the economic system in growing within the boundaries of what the authors call the *Neo-Schumpeterian Corridor*.

Figure 1: Neo-Schumpeterian Corridor.



Source: Hanusch and Wackermann (2011, p. 64).

As explained in Hanusch and Wackermann (2011, p. 65), the idea «of such a corridor presupposes that the political sphere can [...] take the appropriate measures that can effectively and opportunely tame and dominate those forces in a capitalistic system which continuously try to go through the roof and risk exiting the corridor towards an excessive growth path». At the same time, policy makers «have to make sure that an economy will not fall out of the corridor, and that it will not have to cope with economic stagnation».

Probably nobody has better described than Schumpeter the conflict happening between innovative and strongly growing industries and slowly developing sectors in a dynamically growing market economy; he summarized that conflict with the famous expression “creative destruction”. In such a scenario, the more dynamic industries attract «the attention and interest of all those economic actors who desire to participate in the boom in fast-growing domains as financial investors, and who will also want to enjoy the high returns achievable» (Hanusch and Wackermann, 2011, p. 66). The role of expectations and of the financial markets – described in the first paragraph – come back here as generators of a «finance-based overheating that can topple the whole economy into a severe crisis» (Hanusch and Wackermann, 2011, p. 66). As explained by Minsky’s financial instability hypothesis (Minsky, 1982 and 2008), during a boom following a tranquillity period «innovative debt practices and speculative excesses» are encouraged and an «unrecognized system fragility evolved» (Prychitko, 2010, p. 206).

How can a progressive capital gain tax help keep the system moving within the boundary of the corridor without limiting the positive effects produced by profit-seeking behaviours? According to Hanusch and Wackermann (2011, pp. 68-69), this tax could be an automatic stabilizer to investment behaviour. As it is easy to realize, the proposed scheme will generate a situation where the lower the return the lower the tax rate. It is well known that, in general, low return investments are the ones linked with low risk and therefore such a tax would favour conservative behaviour:

*Overall, we would see a shift in the behavior away from highly speculative investments promising a high rate of return, because some investors will lose interest because of the increased tax burden. In a situation where the economy finds itself above the corridor, fewer people will join the bandwagon, and the dangerous bubble formation might evolve at a slower speed. This would give the system the chance to slow down on its own or integrate the highly dynamic sectors in such a way as to widen bottlenecks before a looming breakdown.*

*In times when the economy is stagnating and below the neo-Schumpeterian corridor, the low tax rates incite investors to leave their money in the capital market and support a sustainable development. [...]*

*Furthermore, the government would increase its tax receipts above average in boom times due to the rising tax rates and could, theoretically, use the money to support the economy in times when it nevertheless falls through the corridor. (Hanusch and Wackermann, 2011, pp. 69-70).*

With this scheme, innovative industries may still attract investors at the beginning of their expansion, when expected returns are low and financial resources are more needed, while the influx of second-comer speculators may be contained precisely because they tend to enter the game when returns are rising and therefore they could be discouraged, at least to a certain extent, by increasing taxation. Thus, less money is invested when returns are on the rise and speculation-induced overheating could be prevented. The anti-cyclicality is then built into the scheme (Hanusch and Wackermann, 2011, p. 71).

### 3. Conclusions

The present brief had two main aims. In the first place, we wanted to stress how business cycles are, to a certain extent, unavoidable, though they can be moderated; as a consequence of profit expectations and because of the role played by financial markets, capitalist economies develop by facing oscillations.

The second point is that, in tackling such waves, an institutional approach should be preferred to political interventionism (Garrison, 1992, pp. 176-177). Among the institutional reforms to be implemented with counter-cyclical purposes, we suggest a tax reform for Malaysia resting on three pillars:

- ↳ reform income tax to balance the introduction of the proposed GST and CGT;
- ↳ a progressive GST replacing the existing and controversial SST;
- ↳ a progressive capital gain tax, inspired by the model proposed by Hanusch and Wackermann (2011).

We believe that the scheme presented here would present the following advantages:

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It goes without saying that such a reform has a chance to achieve its targets only if it is accompanied by fiscal discipline and by rationing public expenditures, paired with a growing effort toward accountability.

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