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## DECEM: FINANCIAL ALTERNATIVES FOR DEVELOPMENT AID (2)

### *The decem tax: a public firm's contribution to development*<sup>2</sup>

The western society of the present world is sustained upon an economic and financial basis that has formed over the decades and throughout successive crisis that hit hard countries and societies through forced devaluations, stock bursts and crisis that made the so-called *capitalist system* mature.

A society vertebrated from the very bottom in the principles of a free market, of the law of supply and demand, in which the entrepreneur is rewarded when a project successes and goes public through an IPO.

The most advanced societies operate under the rules of the free market, but are sustained thanks to the tax collection ability of the public administrations. The inability to collect taxes of economies like the Argentine or the Russian fed the economic crisis that hit their financial structures in 1998 and 2002 respectively.

The corporate profit is undoubtedly, an entrepreneur's reward to a job well done. A corporate profit is taxed to a certain degree. A corporate tax represents the basis to determine the market value of a public firm.

<sup>1</sup> About the author: Jaime Pozuelo-Monfort graduated from *Universidad Politécnica de Madrid* in 2000 with a master's and a bachelor's in telecommunications engineering, having also studied two years as an exchange student at *Telecom Paris* and *Universität Stuttgart*. Subsequently he earned master's degrees in business administration from *College des Ingenieurs* in Paris, in financial economics from *Universidad Carlos III de Madrid*, in financial engineering from the *University of California at Berkeley*, and in economic development from the *London School of Economics*. He currently pursues a master's in public administration at *Columbia University*, and will start a master's in international law and politics at *Georgetown University* at this fall. He has worked in the technology sector in Madrid, Stuttgart and Paris, and in the financial industry in New York City and London. His interests lie in the interaction between financial economics and economic development. In addition he is a columnist in written and electronic press. He speaks English, French, German and Spanish fluently, and has a beginner's level in Arabic, Italian, Portuguese and Russian.

<sup>2</sup> This is the second article of the decem series, a series of ten articles fundamentally innovative that aim at the proposal of alternative financial mechanisms to considerably raise the amount of funds available for development in the third world. Throughout the series, the author will stress the implementation aspects of the suggested ideas and will propose arguments for and against.

The stock market is a key element to understand the economic stability of a sovereign state. It allows for the financing of large projects, at the same time that it reduces their cost of capital. It makes access to capital more horizontal and democratic and enables the small investor to share the earnings, if any.

An environment, the one described above, that *ex ante* seems satisfactory, satisfactory if the power is not divided into a small number of parties that end up playing the role of Adam Smith's invisible hand. An environment, the one described above, that rewards the entrepreneurial skills of the individual, at the same time that it penalizes the medium class worker that, with greater and greater difficulty, finds the hoped for stability, a stability searched for by all of us who are part of the welfare state.

The success of multinational firms is not only a result of their good management in the present tense. It is a success linked to the favoritism of the old times, to the abuse of a dominant position, to the malpractices of the negotiation power vis a vis fragile states, states controlled by despotic dictators, to the exploitation, in past decades, of natural and human resources.

The western society provides opportunities, through its multinational firms, to societies in developing economies. But it is to be blamed as well, for its past policies that had nefast consequences in the present reality of the poor world.

Let the entrepreneur continue to have the motivation of taking risks in a personal project, to wake up every morning with the passion to see his or her business prosper. Let the entrepreneur be rewarded through the retention of the corporate profits. But let societies be compensated, societies that suffered from the abuse of the colonization process throughout centuries of history, compensated with the benefit of sharing part of those earnings, earnings that today represent a key *raison d'être* of the capitalist system in the so-called industrialized nations of the world.

#### THE STOCK VALUE

One of the key principles of financial economics deals with the computation of a firm's stock or market value. The technical definition would say that a firm's market value is determined as the summation of the present value of future cash flows. Such an expression is just the sum of future profits, present-valued to today's value of money. It is not the same story to earn one million dollars today, than to earn the same million in a year's time, or in ten years' time. Prices increase because there is inflation, an economic phenomenon that explains the loss of monetary value as time passes by.

The future profits are subject to uncertainty, to macroeconomic uncertainty, to risks of various sorts (operational risk, market risk, credit risk, exchange risk, et cetera). As a result future profits so computed to determine a firm's present value, are indeed expected profits. It is a game of expectations, expectations rule, if expectations are beaten the firm's market value will increase, otherwise the market value will decrease.

Based on the previous reasoning, the evolution of a firm's market value as a function of the established corporate tax can be derived. The greater the corporate tax is, the smaller

the corporate earnings. Therefore a firm's market value should diminish as corporate tax increases. Fiscal systems like Ireland's offer a corporate tax well below the mean of other countries of the Euro-zone. Ireland has consequently attracted the headquarters of many corporations for reasons strictly linked to the increase of corporate earnings.

#### A (DECEM) TAX TO AFTER-CORPORATE-TAX EARNINGS

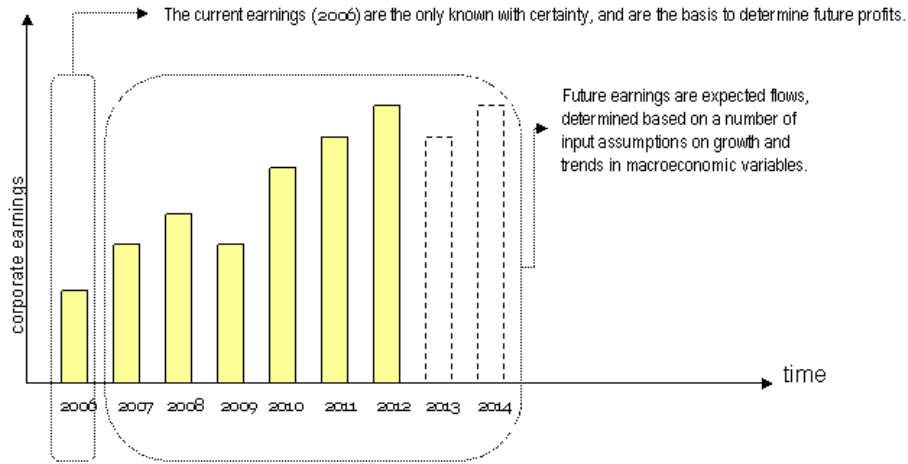
The after-corporate-tax earnings result from subtracting the corporate tax to before-tax earnings. Of each 100 dollars, the Treasury will retain, for instance 30, if the corporate tax is set at 30%. To these after-corporate-tax earnings we suggest the application of a second tax, called **decem tax**, consisting of investing in a large investment fund a 10% of the after-corporate-tax earnings. In the previous example the firm should devote 7 out of each 100 dollars to this large investment fund.

The reader may think that the after-decem-tax earnings decrease from 70 to 63 dollars for each 100 dollars of before-tax earnings. As a result, a firm's market value will automatically fall by 10%. The apparent conclusion is that the adoption of such a measure would automatically make the stock market lose 10% of its total value when adopted.

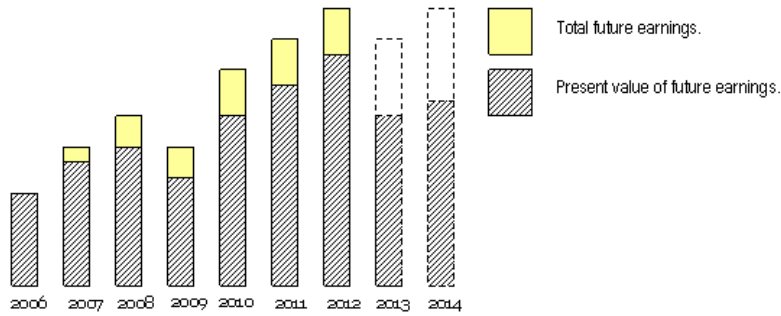
The educated reader in financial economics should think in terms of a firm's financial statements: the income statement and the balance sheet. The latter consists of assets and liabilities. We propose that the 10% of the remaining after-corporate-tax earnings be invested in an investment fund, to be managed according to a set of ethical and sustainable criteria. The profits of this investment fund will be used as funding for development aid in developing and third-world economies: basic infrastructure, education, healthcare... This firm's contribution of its 10% after-corporate-tax earnings will still be an asset to the company that however will not be able to manage it directly. This contribution will be freed in case of the firm's bankruptcy, situation in which the firm's shareholders will be able to access it in order to minimize losses and increase the recovery rate accordingly.

The decem-tax, consisting of retaining a 10% of after-corporate-tax earnings, will contribute to increase the principal of a large investment fund, which profits from the investment strategies will be devoted to funding for development.

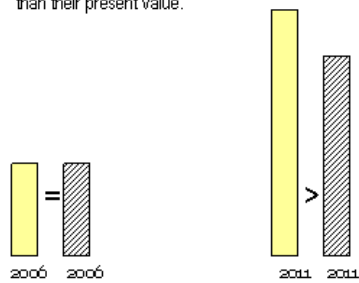
Would a public firm's market value decrease as a result of applying the decem-tax? It could decrease by a half or a full percentage point, without taking into account the impact that a large investment fund so designed would have in emerging economies, where many multinationals already obtain a substantial part of their profits. A positive impact in emerging economies will tend to compensate the loss of market value linked to the adoption of the decem-tax: the result of adding both trends may be certainly positive.



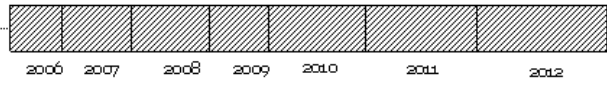
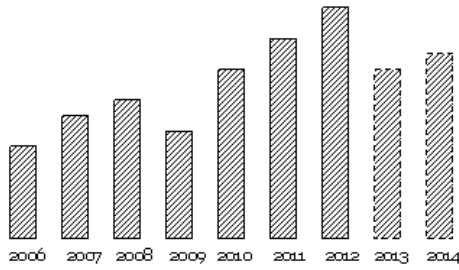
A firm's market value (equity) is the summation of the current earnings (2006) plus the present value of future earnings.



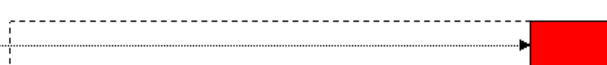
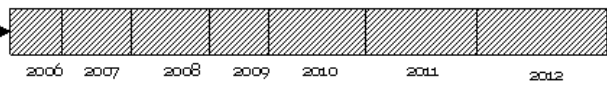
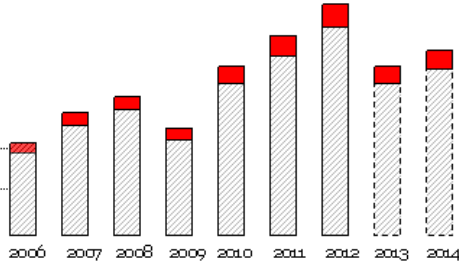
In 2006 the current earnings equal their present value. For any other later point in time, the future earnings will always be greater than their present value.

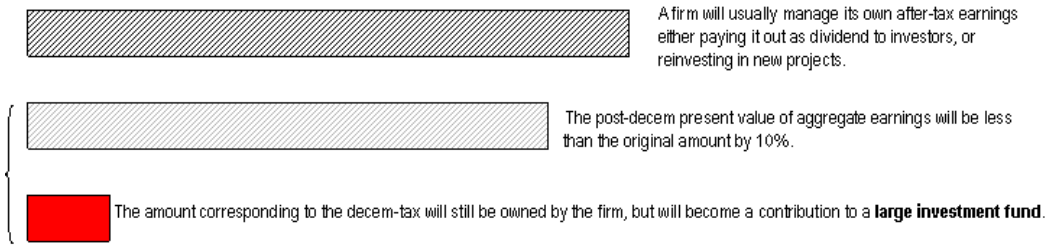


In order to determine a firm's current market value, we will add up the present value of all of its future earnings.



The decem tax migrates 10% of after-tax corporate earnings to an investment fund. This 10% is still an asset to the company, so that there is no loss of market value for the shareholder.





Assets	Liabilities
Cumulative Earnings	Debt
Decem Tax	
Other Assets	Equity

The balance sheet consists of assets and liabilities. Both the post-decem cumulative earnings as well as the amount contributed to the investment fund are part of the asset side.

Only when a firm goes bankrupt, which usually happens when the assets < liabilities, will the shareholders retain the asset contribution to the decem investment fund.

This mechanism minimizes the probability of default and maximizes the recovery ratio, parameters with a huge impact when measuring a public firm's credit risk.