How A Higher Corporate Tax Rate Can Help Keep Money In Australia

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Less than a day after Treasurer Hockey put his proposal for personal income tax cuts, Innes White, Chief Executive of the Australian Industry Group, followed it up with a call for cutting Australia's company tax rate.

He argued that our company tax rate is high in comparison with the rates applying in other countries.

A quick comparison with similar developed countries, where corporate taxes tend to be in the 20 per cent to 25 per cent range, does suggest that at 30 per cent (slightly less for small business) our rate is high.

Out of the 18 most prosperous OECD countries, only three – USA, France and Belgium – have higher rates. Some may be surprised to see the USA in this list (its rate is 35 per cent), but because the USA is such a large and comparatively closed economy, it has always been politically convenient to impose high taxes (as well as levies such as health insurance) on corporations, knowing that they will be passed through to consumers.

That simple argument rarely goes challenged. For example, in commenting on Wednesday's National Reform Summit, ABC Breakfast Show presenter Fran Kelly said that there was "consensus" on the need to get corporate tax lower.

The shortcoming of the simple argument is that it ignores the effect of dividend imputation, whereby Australian shareholders receiving dividends enjoy a tax credit for company tax paid on the profits from which those dividends have been financed.

To illustrate, consider a company that makes a profit of $100, on which is pays corporate tax of $30 at the statutory rate, and chooses to pay a dividend of $40 out of the remaining $70. The individual taxpayer receives a cash dividend of $40 plus a "franking credit" of $17 for company tax already paid. That $40 dividend has been financed by $57 pre-tax profit, on which $17 tax has been paid.

This means that for taxpayers in the $37,000 – $80,000 range, whose marginal tax rate is 34.5 per cent, their tax on dividend income is only 4.5 per cent. If their shares are held in superannuation funds in the accumulation phase, which are taxed at 15 per cent, there is actually a tax refund of 15 per cent.

Out of those same 18 developed countries, Australia is the only country to have full dividend imputation. While some other countries give some relief from double taxation of dividends, most do not.

Dividend imputation reduces the effective rate of corporate taxation. It's hard to be precise – at present Australia's largest firms are paying about 70 per cent of their profits as dividends (a reflection of the low level of business confidence) – but over the long-term firms' payout ratio is more like 50 per cent, meaning that company tax is credited on about half of corporate profits, implying that our effective corporate tax rate is around 15 per cent rather than the headline rate of 30 per cent.

Dividend imputation was introduced by the Hawke-Keating government in 1987. To some it may appear strange that a Labor government should reduce the effective tax on shareholders, in light of the fact that shareholding is concentrated among high-income earners, but that's a superficial perspective – as superficial as the case being pursued by those calling for lower rates of corporate tax.

Its justification is on three grounds.

First, in being available only for Australians with shares in Australian companies, it gives a strong incentive for local ownership, and it provides an incentive for Australian-owned companies to pay tax in Australia rather than to shift profits to havens like Luxembourg and Singapore.

As Paul Keating recently wrote in response to calls for reducing the corporate tax rate from 30 per cent to 25 per cent, "do you know any foreigners you want to give 5 per cent of our national company income to?"

A combination of a high notional corporate tax rate and dividend imputation helps keep income in Australia.

Second, it gives an incentive for investors, rich or poor, to invest in shares rather than lower-yielding assets such as savings accounts.

Individual investors are notoriously risk-averse, and tend to invest in low-yield "safe" products, that often result in negative real returns once inflation is taken into account. The beneficiaries of such risk-aversion are the financial institutions and the rich, who borrow at low rates and invest at high rates.

Hence, to help redress the imbalance, the Hawke-Keating government decided to give Australians some encouragement to invest in shares. The Australian Stock Exchange estimates that for top marginal taxpayers the effective tax rate on Australian share investment is 20 per cent, which is significantly lower than the rate on all other classes of investment such as bonds, property and foreign shares. (The same relative benefits accrue to shareholders in other income groups.)

One may find it unreasonable that the well-off who invest in shares pay so little tax.

So-called "self funded" retirees, in fact, pay no tax on dividends, and each year get a full refund of imputation credits from the Tax Office. The inequity lies not in dividend imputation, however, but in the outrageously generous taxation treatment of superannuation.

It's the base rate of taxation on superannuation, and the distortion of the 50 per cent capital gains discount, that need changing, not the comparative benefit of equity investments. Imputation is undoubtedly one of the reasons Australia has achieved a high rate of individual share ownership in comparison with other countries.

The third case for imputation lies in capital allocation theory.

Dividend imputation gives companies some encouragement to pay dividends rather than to retain earnings. Investors receiving dividends may decide to re-invest the proceeds in other more profitable ventures rather than letting corporate boards simply go on taking their firms into less and less profitable expansion.

Australia has developed a reasonably equitable and efficient corporate tax system. When we hear calls to lower company taxes, and read in the government's taxation white paper hints that imputation is unfashionable because it favours local over foreign investors, we should ask who would benefit from lowering corporate tax and abolishing imputation.

One group to benefit would be the financial sector, who would enjoy an even higher spread between what they take in from risk-averse investors and the returns they get from equities.

The real-estate sector too may benefit as people shift from equities to property (worsening our housing problems). Commissions on real estate dwarf the comparatively modest stockbrokers' commissions on share transactions.

The other group to benefit would be foreign investors. Abbott's oft-repeated slogan about Australia being "open for business" is about trying to wring a little more life out a costly and unsustainable economic model – supporting a chronic trade deficit with foreign capital inflows. We need to take ownership of our own economy.