STATEMENT OF REFORM PRIORITIES

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Improving the Taxation of Capital Income

Preamble

The efficiency costs of capital taxation in Australia are likely to be very high.[1] There are several reasons for this. First, capital accumulation and economic growth are highly correlated. Therefore, as capital accumulation responds to net-of-taxes returns, capital taxes may impact on economic growth. Second, in a world of financial innovation and capital mobility it is actually difficult to tax capital. This also implies that the economic incidence of capital taxes might fall on workers (a lower capital stock makes workers less productive and in turn lowers wages). Third, due to information asymmetries, firms' ability to raise credit often depends on the amount of available income that they can commit to repayment of debt. This means that investment becomes responsive to cash flows and own assets. Indeed, empirical evidence suggests that an additional dollar of cash flow may result in an increase as high as $1.2-$1.3 in investment.[2] Thus, the impact of taxes on investment is likely to be even greater than predicted by standard public finance theory. Finally, capital taxation is complex and provides tax arbitrage opportunities that distort behaviour away from social efficiency.

The recognition that taxing capital entails high levels of inefficiency, alongside international competition for capital, has seen a reduction over time in the statutory corporate tax rates in developed economies. Indeed, once the global economy fully recovers, it seems inevitable that

[1] The AFTS Report suggests that capital taxation has the highest efficiency costs among Commonwealth taxes, with society worse off by 40 cents for every dollar collected (AFTS Report, P. 13).

[2] See, for example, S. M. Fazzari and B. C. Petersen (1993), "Working Capital and Fixed Investment: New Evidence on Financing Constraints," *Rand Journal of Economics 24*, 328-342; C. W. Calomiris and R. G. Hubbard (1995), "Internal Finance and Investment: Evidence from the Undistributed Profits Tax of 1936-37," *Journal of Business 68*, 443-482; and R. E. Carpenter and B. C. Petersen (2002), " Is the Growth of Small Firms Constrained by Internal Finance?", *Review of Economics and Statistics 84*, 298-309.

Australia will need to further reduce its corporate tax rate, perhaps to the level suggested by the AFTS Report (25%). Meanwhile, there are changes to capital taxation that can be implemented, which might have a large impact on the economy, and for which the cost in terms of foregone tax revenue might not be high. I am referring to the introduction of an allowance for corporate equity (ACE), which is more fully discussed below. Such allowance should be seen as an additional deduction available to corporations when financing new investment by equity.

Reducing the tax bias against equity financing

A feature of our current corporate income tax system is that it allows for interest but not dividends to be expensed at the corporation level. This feature is shared by most tax systems in the world and it is often seen as a discrimination against equity finance – creating a heavier reliance on debt financing than would otherwise be the case. Although the double taxation of dividends in Australia is avoided at the individual taxpayer level through the dividend imputation system, it is still the case that corporations' capital structure decisions can be distorted by the tax advantage of debt over equity. For example, in an increasingly global financial market, equity finance often comes from non-residents who by and large do not have access to dividend imputation. Therefore, the current imputation system does not reduce the cost of capital for these corporations with access to the international stock market.

The extent of the distortionary impact of the tax treatment of debt versus equity depends upon other tax shields such as depreciation allowances and tax loss carry forwards. That these distortions exist, however, is relatively well understood. For example, existing empirical evidence for Germany suggests that, on average, an increase in the corporate tax rate of 10% results in an increase of leverage by 5%. This number, however, is substantially lower for small corporations that enjoy other tax shields.[3] Similarly, the average effective tax rate in Australia varies considerably across industries reflecting both the different capital intensity levels but also the relevance of other tax shields (accelerated depreciation and the level of debt financing). Further, the asymmetric treatment of tax losses results in risky investments being overtaxed.

An ACE addresses the difference in the tax treatment of debt and equity by allowing firms to deduct a notional interest rate on their equity. The idea is to eliminate the taxation of normal returns not rents. Therefore, a starting point for the imputed interest rate is the risk-free rate. However, as corporations cannot perfectly offset losses, an alternative (higher) imputed rate such as the average corporate bond rate should be explored. Moreover, the proposal is to introduce an ACE for new equity only to minimize tax arbitrage.

The notion of an ACE is neither new nor untried. It has been considered in the optimal tax literature since at least the 1970s; it has been brought to the policy arena by the Institute for Fiscal Studies in the early 1990s and it has been tried and continues to be used by a number of countries. It has also been recently considered by the Mirrlees Review.

There are several advantages associated with an ACE above and beyond the reduction in the tax bias

[3] See, for example, N. Dwenger and V. Steiner (2009), "Financial Leverage and Corporate Taxation: Evidence from German Corporate Tax Return," DIW Discussion Paper 855.

towards debt. Conceptually, an ACE is investment neutral. That is, no tax is charged on marginal projects; for such projects the imputed return should be equal to the actual pre-tax profit and therefore no tax would be due. This is different from the current system whereby marginal projects involving equity finance would be taxed and, therefore, are not pursued by investors. Thus, an ACE has the potential to increase investment considerably. Moreover, the introduction of an ACE eliminates the concern with the effects of different depreciation methods. An increase in depreciation in early years reduces the equity base and hence the ACE in later years so that net present value remains unchanged.

It should also be noted that there is no need to eliminate the current dividend imputation system although it will become less relevant over time as more corporations take advantage of their ability to deduct an imputed cost of equity or as a result of other changes in personal taxation.

To sum up, the introduction of an ACE should be given serious consideration. An ACE will mitigate the existing tax advantages of debt, it can be implemented under the existing corporate tax rate system and will likely lead to an increase in the amount of investment, a reduction in the cost of capital and a productivity-led increase in economic growth. Finally, the above arguments suggest that serious consideration should also be given to the introduction of an equivalent approach to the taxation of individual savings. For example, a possible approach is a personal tax system where the normal rate of return on any form of savings is tax free as considered by the Mirrlees Review.

How to Finance it?

There are two important considerations when deciding how to finance the introduction of an ACE. First, the arguments above suggest that there might be a substantial **efficiency dividend** associated with the introduction of an ACE. In particular, the tax relief to marginal projects means that projects that are not currently undertaken because of the corporate tax rate will be undertaken. Moreover, a potential reduction in the cost of capital would have significant economy-wide impact with consequently higher overall tax revenue. Appropriate modeling needs to be undertaken to determine the quantum of the efficiency dividend and, therefore, the likely reduction in tax revenues. Second, to the extent that the introduction of an ACE will result in a loss of revenue in the short run, basic public finance principles should be taken into consideration. That is, the foregone tax revenue can be financed by more efficient taxes – taxes on immobile rents (e.g., mineral resources rent tax, and land taxes) or a broad-based consumption tax (e.g., an improved GST).

LIST OF ATTACHMENTS