Taxing Capital Income: Options for Reform in Australia

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Inland Revenue
Te Tari Taake

Introduction

- Stimulating and clear paper
- Outlines deficiencies with the current tax system
- Suggests a possible direction of reform
  - not tinkering at the margin!
- Very clever and coherent reform
- At the same time the reform is fragile
- Depends on an accrual capital gains tax at the shareholder level
- Important to have some “Plan B’s” if parts of the reform are not politically acceptable

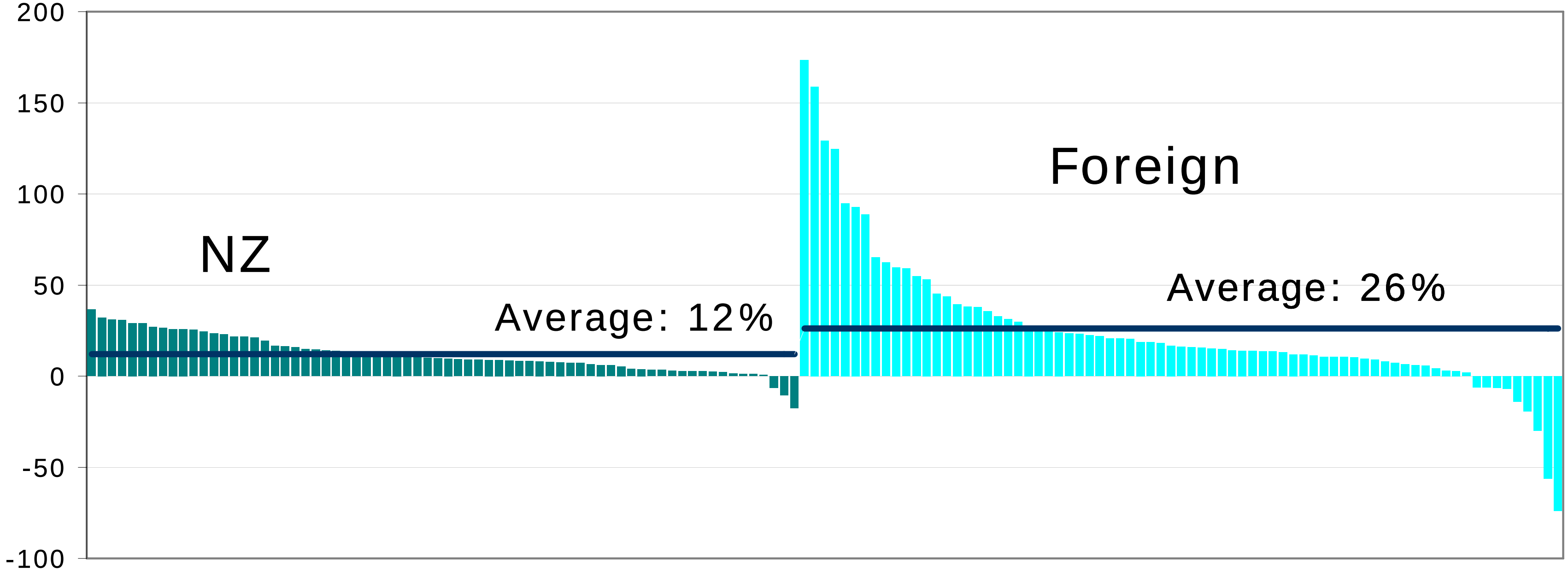
Economic Rationale

- To the extent that company tax imposes tax on normal return on capital, this undermines production efficiency
- Provided capital is perfectly mobile, this tax is passed on to less mobile domestic factors (labour and land) but less efficiently than if they were taxed directly
- ACE company tax system continues to tax location-specific economic rents

Importance of Location-Specific Rents

- These are likely to be much more important in island economy like Australia or NZ than land-locked country in Europe
- Makes little difference whether set up factory in Austria or Germany close to border
  - can supply same market in either case
- At least in NZ, large bulk of foreign companies are set up to supply goods to local market
- Location specific rents more likely

Top 200 NZ Non-Financial Companies: After-tax average return on total equity



Taxation of Economic Rents

- For NZ domestically-owned companies, after-tax returns:
  - mean of 12%; median of 9%
- For foreign-owned companies, after-tax returns:
  - mean of 26%; median of 18%
- Averages are over 10 years for companies with at least 5 years' data
- Individual firms typically supply domestic market rather than export from NZ
- Economic rents especially for foreign-owned firms seems important
- Deep cuts to company rate could provide windfalls to foreigners and higher taxes on domestic residents
- Is Australian data similar?

Economic Rents

- Key element of Sorensen/Johnson reform is that ACE company tax system retains tax on economic rents rather than there being major company rate cuts
  - seems sensible
- Also dual income tax with 20% flat tax rate on capital
- Because company tax only taxes economic rents, critical to tax return to capital at shareholder level:
  - for listed companies through tax on dividends plus tax on accruing capital gains
  - for unlisted companies through tax on dividends plus 20% tax on retentions

Potential concern

- How viable is an accrual-basis CGT?
- No countries have implemented and retained
- Important to have plan B for listed companies. Possibilities:
  - Risk-Free Return Method (RFRM) for listed companies instead of tax on dividends plus accruing gains or
  - taxation of retentions as suggested for unlisted companies
- Need one of these options to keep system coherent

Housing

- Suggests RFRM on owner-occupied and rental housing
- Would address major bias favouring owner-occupied housing over business investment and boost economic efficiency
- Suggested in NZ in 2001 by McLeod Review
- Expect strong political pressures
- In NZ after intense lobbying it was dismissed by government within a day of it being suggested

Housing

- Unlike taxing accruing gains, RFRM on housing is not essential to coherence of basic reform
- Would RFRM on net equity in housing possibly at low rates or with very slow phase in be more feasible?

Transition

- Suggested that ACE just applies to new equity
- Logical in principle
- Is attempting to do so like trying to defy gravity?
- Huge pressures on liquidations and new start ups
- Would firms become highly geared prior to introduction and then replace debt with equity?

Conclusion

- Innovative and very coherent reform
- Likely to have important effects in boosting efficiency
- Critical to have accruing capital gains tax or equivalent
- Dual income tax system involves lower tax rates on capital
- Needs buy in that fair to tax capital incomes at lower rates than labour incomes
- Nordic countries have clearly implemented
- Less attractive for NZ than Australia because of our higher labour mobility
  - 3% of skilled Australians live abroad;
  - 24% of skilled NZers live abroad.