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CORPORATE TAXATION

John Hyde

Most people are by now aware that Australia has a foreign debt problem and that it is serious. Yet, as the chairman of Western Mining and BHP, Sir Arvi Parbo, pointed out to a group of Liberals in Melbourne, the 1987 Federal election was fought with barely a mention, by either party, of the debt problem. (The campaign had been dominated by the Joh-for-Canberra nonsense.) Sir Arvi's criticism was a far greater indictment of the Liberal Party than I suspect most of his audience realised---but then, Sir Arvi is a polite man.

Economists and public-policy makers agree that Australians must consume less to invest more in productive activities. At that unsatisfactory point, not only the consensus, but the whole debate itself comes to a near stop. To date there has been little public discussion about why Australians consume resources which, in their own and their children's interests, they would be better investing. There has been even less said about what should be done about it.

One explanation is that, by nature or by training, Australians are spendthrift---that we live for today trusting that somehow tomorrow will take care of itself. Another explanation---which I find more compelling---is that the government is distorting the incentives which determine whether we invest in productive enterprises such as mines and factories, build bigger houses, or have a party now. One does not have to look far to find one major distortion---the tax system.

The work ethic is a much exaggerated phenomenon: people work for reward. That is, they work in order to consume. But they must decide whether to consume now or whether to save now. War bonds may be an exception, but people do not as a rule save for patriotic reasons---they save to gain the option of consuming later.

Somebody---let us call him Paul---who has earned $100 will pay, say, $30 income tax. He then has $70 to spend on current enjoyment or to save. If Paul saves, particularly in these days of high inflation, he will not put his money in a sock under the bed. Instead, he will invest it to earn further income which, in turn, he may consume or invest. The additional income is a reward for delaying his consumption.

Paul's choice between a $70 party or a $70 investment is tilted by the government in the direction of the party. If he invests, Paul will pay not only the tax he would have paid had he decided to consume but his reward for saving---for delaying the party---is also taxed. Money which is invested is, in a sense, double taxed by the present income-tax system---the decision to save is itself taxed.

The investment alternative is, moreover, made less attractive by the effect of inflation. Paul's reward for saving rather than consuming is reduced not only by tax but also by the effect of inflation upon his capital. Say he invests $70 at 15% interest. Nominally it earns $10.50, but of this he loses $3.15 tax (30% of $10.50) and $5.60 (8% of $70), which is the effect of inflation on his capital. His reward for not treating himself to a party now is now only $1.75. If he were in a higher tax bracket than 30%, or interest rates were lower, he would actually lose.

Should Paul put his savings in a company which in turn placed the money at 15% interest he would face yet another penalty. The $70 would earn $10.50 for the company but then it would attract company tax of 39% leaving post-tax earnings of $6.40. If, say, half of the post-tax earning, namely $3.20, were distributed as a fully-franked dividend, the dividend would give Paul a tax credit $2.05---that is it would allow him to reduce the tax attributable to his other earnings, if he has other earnings in that year, by 40 cents. His net cash-in-hand reward is a reasonable $3.60, but dreadful things have happened to his $70 of capital. As before, inflation has robbed it of $5.60 and company tax has reduced the undistributed post-tax income to only $3.20. In constant dollars Paul's investment is now worth only $67.60. Over all, he has earned only $1.20. If his marginal tax rate had been the maximum and interest rates only 15% his future consumption would have been 24 cents LESS than he could enjoy now.

Australian investment is poor because the rules discourage investment---even the strictest Calvanist does not save to give his money to the government. Before we can expect sustained high rates of saving and investment, the tax system must be rejigged to remove the penalties from investment and from incorporation.

There is more: the tale of national suicide by fiscal poisoning does not end with consideration of the aggregates. Paul's investment income may be taken in cash which, as we have seen, will attract income tax. The same principle applies to some cash substitutes which are caught by fringe benefits tax. The rewards derived from some other investments are, however, not taxed.

The investments which are untaxed either by the government or inflation are those which yield comfort, prestige or other psychic income---eighteenth century clocks, works of art, pleasure boats and homes. Unfortunately, these investments tend not to earn foreign exchange. Loopholes and illegalities aside, it is the taxed investments---interest-bearing deposits with financial intermediaries such as a banks, shares in companies, income-earning capital equipment such as tractors, lathes, trucks, boats, farms, factory buildings and mines---that earn the foreign exchange to service the foreign debt.

Thus, not only does Paul have an incentive to spend up now, but should he be satiated to the point where his choice really is between sock under the bed and investment, then he has a government-given incentive to invest in things which will not pay the foreign creditor.

There is one final distortion: should Paul, in spite of income tax, company tax and inflation, feel constrained to invest in the productive part of the economy, then tariffs, occupational licenses and other government-made barriers to free exchange will encourage him to put his $70 in the least efficient industries.

There are, of course, many ways around these distortions; they tend, however, to be illegal. Bad and unnecessary law, dearly beloved, is one reason why Paul has the Australian economy is up the creak in a barb wire canoe without a paddle.

ENDS

$48.75 7.31

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To callculate the Loss