# Company tax and foreign investment in Australia

***…do you know any foreigners you want to give 5% of our national company income to? Any deserving cases out there?*[1]**

Discussion paper

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[1] Keating PJ (2013) 'Dividend imputation and superannuation are worth fighting for', *Cuffelinks*, 21 February.

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# Summary

The government's 10-year company tax cut plan was announced in the May 2016 budget but was always going to be difficult to sell as an urgently needed reform. Since then the debate has effectively shown that there is nothing in it that would increase the incentive to invest. This reflects the role of dividend imputation which acts like a withholding tax for dividend recipients. That means that any cut in company tax would thereby reduce the amount withheld on behalf of dividend recipients and so increase the amount shareholders will have to 'top up' at tax time.

These arguments do not apply to foreigners who will unambiguously benefit from Australian company tax cuts. We contend that recognition of the role of foreign investors has caused the Treasurer to downplay any domestic considerations but instead concentrate on the role of foreign investment. Hence foreign investment is presented as a 'must have' and the company tax cuts become necessary to encourage foreign investment. Others such as former Prime Minister Paul Keating see it as ridiculous that Australia contemplates giving a large sum of money to foreigners.

The rest of this paper examines whether indeed a company tax cut is likely to boost foreign investment in Australia.

Australia's company tax rate has gone from 40 per cent in 1960 to a peak of 49 per cent in the 1980s to 30 per cent in 2001 where it is now (except for the 28.5 per cent rate applying to small companies with turnovers to $2 million beginning in July 2015). Under the thesis that tax cuts encourage foreign investment we should have seen first a fall in foreign investment to the late 1980s and then a rise from the late 1980s to the present. In fact the opposite happened in the period to the mid-1980s and then there seems to be no trend in foreign investment as the company tax rate fell.

Whatever the past the Treasurer suggests there is 'fight' to attract foreign capital and company tax is the weapon. That caused us to examine where Australia's foreign investment comes from and the tax arrangements in the source countries. We find that Australia's stock of foreign investment is dominated by 13 countries, some with higher and some with lower company tax rates.  Nine of these countries have lower company tax rates than Australia's, yet they invest in Australia out of proportion to their significance in the world economy. For example, the UAE's share in foreign investment is twice its share of the world economy and its company tax rate is zero!

At first the UK seem to confirm the tax cut thesis. It has recently lowered its company tax rate and now shows large negative figures for foreign investment in Australia.

However, that large negative figure reflects financial derivatives and without those UK investment flows have been much higher than the UK's significance in the world economy and so contradicting the thesis.

We also examined Foreign Investment Review Board figures which confirm that a lot of Australia's investment comes from countries with lower company tax rates. By value 71 per cent of foreign investment applications come from countries with company tax rates lower than Australia's rate and by number a large 97 per cent come from countries with company tax rates lower than Australia's rate. All of this raises the question – if Australia is already successful at attracting foreign investment why would we give tax cuts to foreigners?

Throughout the whole debate it is assumed that company tax rates are the critical variable affecting investment. However, any returns to the ultimate investors will depend on the individual tax system as well as the company tax and the interaction between the two. When we look at company tax alone Australia has the equal fifth highest among OECD counties yet when we examine the implied total tax rate Australia falls to fourteenth and is only marginally above countries such as the UK.

We conclude that the available evidence suggests that Keating is indeed correct—Australia is on the brink of handing a large gift to foreign investors while the evidence suggests Australia will not get even the dubious benefits of an increase in foreign investment.

# Introduction

Australia has witnessed a debate about the appropriate rate of company tax for some time. Following the 2015 budget the company tax rate was lowered to 28.5 per cent for small companies with a turnover up to $2 million per annum as of July 2015. In the 2016 Budget the government announced a ten year plan for cutting the company tax rate from 30 per cent now, or 28.5 per cent for small companies, to a common 25 per cent in 2026-27. In earlier papers The Australia Institute examined a lot of the arguments supporting cuts to company tax and found many of them lacking theoretical or empirical support. Arguments suggesting increased investment, employment and economic growth were found wanting.

One thing that strikes observers is the very slow timetable in that 10 year plan. Such a slow implementation plan contradicts the apparent urgency of the government's agenda. The lack of urgency and importance is highlighted by former Treasurer Peter Costello's comments when he said personal tax cuts were a bigger priority than company tax cuts. He added 'Whatever the company tax rate is, if your individual tax rate is up around 50 per cent then it's still a big drag on growth'.[2] Without endorsing the arguments for lower personal tax the impression now is that the company tax debate has recognised that there is no incentive for increased investment and employment on the part of domestic investors but there remains the argument about the incentive for increased foreign investment with lower company taxes. This paper makes the case that those arguments are also flawed.

[2] Danchert S and Martin P (2017) 'Peter Costello backs personal tax cuts over company tax cuts', *The Sydney Morning Herald*, 5 January.

# Foreign investment is now the issue in company tax cut proposals

In a speech to the Australasian Finance and Banking Conference the Treasurer, Scott Morrison, spoke about the historic and continuing importance of foreign investment for Australia's economic development and hence, in his view, the need for tax cuts for continued foreign investment.[3] There was no mention of any benefits for Australian capital owners. Previously it was just asserted that the company tax cuts would produce benefits for companies that would spread out to the rest of the economy in other 'benefits'. For example, the Treasurer's earlier budget speech contained general lines about the benefits of the planned tax cuts; 'This is an important measure in securing our future prosperity' and: 'If we wish to continue to see our living standards rise with more jobs and higher wages, we need to ensure our tax system encourages investment and enterprise'.[4]

The change from the general to a particular focus on foreign investment implicitly acknowledges that with the complications of dividend imputation there is no benefit to Australian owners of capital.[5] Dividend imputation (further explained in an appendix) is basically a mechanism that give some resident taxpayers credit for company tax deemed to have been paid on their behalf through the company tax. 'Franking credits' attached to dividends are the actual mechanism for delivering tax credits for dividend recipients. Dividend imputation implies that any benefit to company owners through lower company tax is forfeited in the personal income tax system because company owners will have commensurately lower franking credits to apply against their personal tax liabilities.[6] At the time of the 2016 Budget the government released a paper on the Treasury modelling of the company tax cuts by

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[3] Morrison S (2016) Speech to the *Australasian Finance and Banking Conference*, 14 December.

[4] Morrison S (2016) *Budget Speech*, 3 May at http://www.budget.gov.au/2016-17/content/speech/download/Budget-Speech.pdf

[5] The role of dividend imputation and how foreign and Australian capital owners are treated differently is discussed in Kouparitsas M, Prihardini D and Beames A (2016) 'Analysis of the long term effects of a company tax cut', *Treasury Working Paper* No 2016-2, May; and Dixon JM and Nassios J (2016) 'Modelling the impacts of a cut to company tax in Australia', *Victoria University Centre of Policy Studies Working Paper*, No G-260, April.

[6] The same is true of some other domestic entities such as superannuation funds. Whether or not a dividend recipient is better or worse off will depend on the dividend payout policy of the companies paying the relevant dividends.

Treasury officials Kouparitsas, Prihardini and Beames (KPB).[7] This paper correctly accounts for Australia's dividend imputation system and so showed a benefit to foreign investors but no benefit for Australian investors, indeed with a small cost to domestic investors.[8] The result is that any response to a lower Australian company tax comes from foreign investors if indeed there is any response. The Treasury officials' position on the difference in company tax cut incentives for foreign and domestic investors was also emphasised in an earlier study by Janine Dixon.[9] Incidentally both studies suggested trivial benefits if any to Australia and then only after a long transition period with negative benefits in the case of the Treasury officials' paper. Indeed the impacts are so small that former head of Prime Minister and Cabinet, Mike Keating, remarked:

> Frankly it is hard to think of reasons why this extension of the company tax cut would represent value for money, as it is unlikely to make much difference to investment nor growth. Indeed, company tax has been cut by a lot over the last few decades in a lot of countries, but in no country was there a significant impact on investment, output or employment.[10]

The Treasurer's speech suggests that foreign investors are essential because they are the only real beneficiaries of the proposed company tax cuts.[11] For example, the Treasurer said:

> Much of Australia's economy wide debt has been financed by domestic savings but some has also been financed from international sources as Australian investment opportunities exceed domestic savings… as a large, resource rich country with relatively high demand for capital, Australia has relied on foreign investment to meet the shortfall of domestic savings.
>
> So successive waves of foreign capital has allowed the Australian people – including our generation – to enjoy higher rates of economic growth and employment, and a higher standard of living than could have been achieved

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[7] Kouparitsas M, Prihardini D and Beames A (2016) 'Analysis of the long term effects of a company tax cut', *Treasury Working Paper* No 2016-2, May.

[8] The intuition of this result is that with a lower company tax rate in Australia foreign investors invest more in Australia which drives down the general rate of return somewhat which then impacts on Australian investors. See Kouparitsas et al.

[9] Dixon JM and Nassios J (2016) 'Modelling the impacts of a cut to company tax in Australia', *Victoria University Centre of Policy Studies Working Paper*, No G-260, April.

[10] Keating M (2016) 'Mid-Year Economic and Fiscal Outlook, 2016', 21 December at http://johnmenadue.com/blog/?p=8753

[11] The other possible winners, tax avoiders, are unlikely to be used as an argument for cutting company taxes.

> from domestic savings alone. Such capital is a necessity. It is a must have – not a nice to have.

Foreign investment has become a 'must have' in Treasurer Morrison's view. But it is certainly not clear whether the majority of Australians understand that only foreigners will benefit from a company tax cut. In 2013 Paul Keating, the architect of the dividend imputation system in the 1980s when he was Treasurer, rhetorically asked:

> …do you know any foreigners you want to give 5% of our national company income to? Any deserving cases out there? Or should we leave the company tax rate where it is, as a withholding tax, for the promotion of Australian investment and for the benefit of Australian taxpayers?[12]

The rest of this paper asks whether the company tax cut lobby have the answer to Keating's question.

Australia has never had any problem attracting foreign investment but the debate now introduces the element of competition with other jurisdictions that are changing their tax rates. For example, company tax cut proponent Jenifer Westacott from the Business Council of Australia, stresses competition between countries for investment and cites President Elect Trump whose campaign included a 15 per cent company tax rate at the federal level.[13] The Treasurer in the speech already quoted said 'We know that the Trump administration will be bringing down tax cuts for companies to 15 per cent'. The Treasurer's has referred to 'the fight to attract the investment capital' and suggested Australia has 'to be a flexible and competitive economy to attract investment…another large part of that story is competitiveness on tax'.

In passing it seems rather extraordinary that our Treasurer claims to 'know' something that has yet to be negotiated through the US political system. A more developed and detailed proposal is put by Paul Ryan, the speaker of the House of Representatives, who advocates a 20 per cent company tax rate financed by measures such as denying the deductibility of interest and the so-called 'border adjustment' measures.[14] That package of measures would make it impossible to simply compare Australia's 30 per cent rate with the US 20 per cent tax rates. Trump is also unlikely to present a clean cut to company taxes without some complicating offsets. We really need to see the full package of measures to make an assessment. However, if such a tax cut is regarded as

[12] Keating PJ (2013) 'Dividend imputation and superannuation are worth fighting for', *Cuffelinks*, 21 February.

[13] Individual states also levy a tax on corporate incomes.

[14] 'Boarder adjustment' measures include on the one hand not taxing profits on exports but also not allowing imports as a legitimate deduction. See The Economist (2016) 'American corporate tax: Gain and pain', *The Economist,* 17 December.

a serious enough to involve a 'fight' with the Americans to 'attract investment' it is curious that we have not seen any attempt to discourage the Americans and others from implementing such changes. It is almost as if some are looking forward foreign cuts to use as the excuse to cut company taxes.

All of the above begs the question of whether indeed foreign investment will indeed generate benefits for Australians. Quiggin[15] has made the point that while foreign investment may well increase Australia's GDP it does not necessarily increase Australia's gross national income which is the more appropriate measure of the economic 'benefit' to Australians.[16] However, in the rest of this paper we leave open the nature and extent of any benefits to Australians from foreign investment.

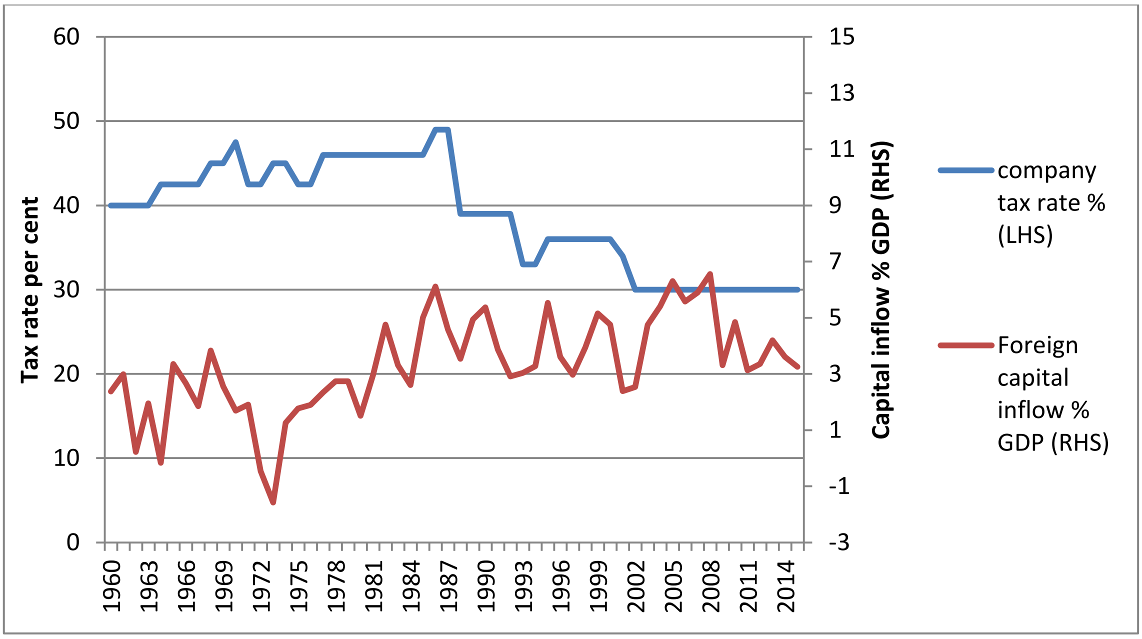
[15] Quiggin J (2012) 'The problem with GDP', *Business Spectator*, 26 June.

[16] Benefit is put in inverted commas to emphasise that we do not regard any of the national accounting measures as good measures of the welfare of the people of Australia. However, 'domestic' in the national accounts, as in
Gross Domestic Product or GDP, refers to output or income generated domestically. By contrast 'national' in the national accounts aggregates refers to magnitudes generated or received by Australian nationals or permanent residents.

# Australia's previous experience

In this section we examine Australia's history to see if earlier changes in the company tax rate support the Morrison thesis that reductions in company taxes will encourage foreign investment. This builds on earlier Australia Institute research that examined Australia's historic record to see if there was any discernible impact of changes in company tax rates.[17] One of the measures examined in the earlier research was foreign investment and whether it has been influenced by earlier changes in company tax rates. That work is again relevant in the context of the Treasurer's remarks. One of the claims of the tax-cuts-are-good thesis is that foreign investment will increase as company tax rates are reduced. That claim can be tested by examining the record as has been done in Figure 1.

**Figure 1: Comparing foreign capital inflow and company tax rates in Australia**




Source: ABS (2015) *Australian System of National Accounts, 2014-15*. Cat no 5204.0. 30 October and ABS (various years) *Year Book Australia*, Cat no 1301.0 and Australian Government (various years) *Budget Papers*.

The results presented in Figure 1 are important. They appear to show that foreign investment increased as a share of GDP in the period to the late 1980s when, if anything, company tax rates were increasing. By contrast, as the company tax rate was

[17] Richardson D (2016) Company tax cuts What the evidence shows, *The Australia Institute Discussion Paper*, March.

being reduced through the 1990s and early 2000s the level of foreign investment appeared to show no trend. From 1986 when the company tax peaked and then started to fall to the present 30 per cent foreign investment remained quite steady. The mining boom should have increased the level of foreign investment in any event but even that is not apparent. By contrast with the evidence of Australia's history some tax-cut advocates are inclined to cite just one OECD report that found a one per cent increase in the company tax rate would result in a 3.72 per cent reduction in foreign investment.[18] On that basis the reduction in Australia's company tax from 49 per cent in 1986-88 to 30 per cent by 2001 should have generated an increase in foreign investment of 71 per cent from a bit under 5 per cent of GDP to over 8 per cent of GDP. No such thing occurred as is obvious from Figure 1. Over the last few decades foreign investment has mainly fluctuated within the range 3 to 6 per cent of GDP with no hint of any upward trend. Given this history there is no reason to believe the present tax cuts will fare any differently.

[18] For example, PwC (2015) *A Corporate Rate Reduction: the case for and against*, 11 December.

# Competition between countries

In this section we further examine Treasurer Morrison's proposition that Australia is in competition with other countries for foreign investment and so needs to lower its company tax rate. This section compares various countries' share of foreign investment in Australia with the company tax rate in the source countries. This is done by examining first the stock of foreign investment in Australia by source and then the flow of new investment, again by source of that investment.

Some of our earlier work suggested that company taxes cannot be important in the context of competition for foreign capital because Australia receives a good deal of its foreign investment from countries in Asia and elsewhere that have significantly lower company tax rates.[19] The present debate provides a good opportunity to re-examine that issue by comparing Australia's sources of foreign investment with the home rates of company tax in the source countries.

Table 1 shows the *stock* of foreign investment and examines the share of that investment that derives from the main source countries. The stock figure for foreign investment can be thought of as the present market value of all of the foreign investment since European settlement. The figures themselves are obtained from the ABS and were expressed as shares of the total stock of foreign investment in Australia which stands at $3,024 billion as of June 2015.[20] Those are compared with company tax rates supplied by consulting firm Deloitte. Deloitte's figures for company tax rates include all levels of government where relevant.

Table 1 lists the top 13 foreign investment source countries ranked by the value of the shares. After those 13 countries the value of foreign investments was not significant. Table 1 also provides the present rate of company tax in the countries concerned. The tax comparison in Table 1 is based solely on the theoretical company tax rates alone. It is important to stress that the theoretical tax rates may not reflect the actual rates once various tax concessions and other policy measures are taken into account. Also as suggested below, there may be other important factors affecting the investment incentives. The last column of Table 1 presents estimates of the share of the world

[19] See Richardson D (2014) 'The taxation of capital in Australia: Should it be lower?' In Schroeder SK and Chester L (Eds) *Challenging the orthodoxy: Reflections on Frank Stilwell's contribution to political economy*, Springer, pp 181-202.

[20] This is the gross figure that includes all types of foreign investment in Australia. Use of the word 'country' in this paper should not be taken as suggesting all countries being discussed are independent political units.

economy accounted for by the countries mentioned in column 1.[21] Country shares of world economic activity can assist in interpreting the foreign investment figures and, for example, allows the reader to see whether the contributions of a country seem to reflect its relative weight in the world economy.

**Table 1: Foreign investment by source – Stock at 2015**

| | Share of foreign investment % | National company tax rate % | Local company tax rate % | Share of world economy % |
|---|---|---|---|---|
| **US** | 27.2 | 35 | varies | 22.4 |
| **UK** | 17.4 | 20 | | 3.7 |
| **Belgium** | 8.1 | 33 | | 0.7 |
| **Japan** | 6.3 | 23.9 | varies | 6.8 |
| **Singapore** | 2.9 | 17 | | 0.4 |
| **Hong Kong** | 2.8 | 16.5 | | 0.4 |
| **China** | 2.3 | 25 | | 12.7 |
| **Luxembourg** | 2.1 | 21 | 6 to 12 | 0.1 |
| **Netherlands** | 2.0 | 25 | | 1.1 |
| **Switzerland** | 2.0 | 8.5 | | 0.9 |
| **United Arab Emirates** | 0.9 | 0 | 50+ on oil and gas | 0.5 |
| **South Korea** | 0.8 | 22 | 2 | 1.7 |
| **Malaysia** | 0.8 | 24 | | 0.4 |
| **Other** | 24.4 | | | 51.8 |
| **Total all countries** | 100.0 | | | 100.0 |

Source: ABS (2015) *International Investment Position, Australia: Supplementary Statistics*, 2015, Cat no 5352.0, 15 May; https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates.pdf accessed 16 December; IMF (2016) *World Economic Outlook Database, October 2016* at https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx accessed 3 January 2017. Note that the China figure excludes Special Administrative regions Hong Kong and Macau as well as Taiwan.

Australia's foreign investment has been traditionally dominated by the US and UK and that is shown in Table 1 with shares of 27.2 and 17.4 per cent of total foreign investment respectively. The US has a company rate of 35 per cent at the national level but a rate that varies widely at the state level and can give a total of up to 39 per cent.

[21] Those shares rely on the IMF database at IMF (2016) *World Economic Outlook Database, October 2016.* And use GDP expressed in US$ using market exchange rates.

The US share of investment at 27.2 per cent is larger than its share of world GDP at 22.4 per cent. The UK used to be the most dominant source of foreign investment beginning in colonial times and still accounts for 17.4 per cent of the total. The UK has only a 3.7 per cent share of the world economy yet accounts for 17.4 per cent of Australia's foreign investment. Belgium is somewhat of an outlier with a modest 0.7 per cent of the world economy but an 8.1 per cent share in Australia's foreign investment. Japan follows at 6.3 per cent with a tax rate of 23.9 per cent but may be similar to the Australian rate when subnational governments are included. Japan's share of foreign investment in Australia at 6.3 per cent is not too dissimilar to its share of the world economy at 6.8 per cent.

Following that there is an interesting collection of countries that complete the list shown here. These include six Asian countries and the UAE; all of these countries have company tax rates significantly lower than Australia's yet they have a strong presence among Australia's foreign investments.[22] For most of these countries their share of Australia's foreign investment is greater than their share in the world economy. The exception is China and we will consider it further below.

The important point to note here is that among the 13 countries that have the greatest share of foreign investment in Australia, nine countries have lower company tax rates. While a large foreign investment on the part of the US may seem to support the cut company taxes lobby, the UK example would contradict it. As we move down the list all countries after Japan also contradict that lobby with the exception of Korea. Singapore, Hong Kong, Luxembourg, the Netherlands, Switzerland, UAE and Malaysia all invest disproportionately heavily in Australia, yet all have lower national company tax rates.

An argument could be put that the history is irrelevant and we should be examining the current flows of foreign investment into Australia. That is done in Table 2 which examines the same countries and instead of stocks of foreign investment it examines the new foreign investment that took place in the five years to June 2015. The five year period was used to smooth the volatility in the annual figures.

[22] The UAE has a 50 per cent plus rate on oil and gas investments but as far as we are aware UAE interests are not prominent in the Australian energy sectors.

**Table 2: Foreign investment by source – Flow over 5 years.**

| | Share of foreign investment % | National company tax rate % | Local company tax rate % |
|---|---|---|---|
| **US** | 51.88 | 35 | varies |
| **UK** | -41.8 | 20 | |
| **Belgium** | 16.8 | 33 | |
| **Japan** | 11.71 | 23.9 | varies |
| **Singapore** | 7.3 | 17 | |
| **Hong Kong** | 5.5 | 16.5 | |
| **China** | 11.92 | 25 | |
| **Luxembourg** | -0.8 | 21 | 6 to 12 |
| **Netherlands** | 3.3 | 25 | |
| **Switzerland** | -2.8 | 8.5 | |
| **United Arab Emirates** | -3.9 | 0 | 50+ on oil and gas |
| **South Korea** | 2.0 | 22 | 2 |
| **Malaysia** | 1.6 | 24 | |
| **Other** | 22.7 | | |
| **Total all countries** | 100.0 | | |

Source: ABS (2015) *International Investment Position, Australia: Supplementary Statistics*, 2015, Cat no 5352.0, 15 May, Deloitte (2016) Corporate tax rates 2016 https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates.pdf. Note that the China figure excludes Special Administrative regions Hong Kong and Macau as well as Taiwan.

The first things to note about Table 2 are some significant negative figures. The UK figure stands out. In the UK case the large fall in foreign investment represented by the large negative number may well appear to support an argument that the UK is withdrawing investment now that the UK is lowering tax rates. However, inspection of the figures shows the large negative figure is almost entirely due to minus $247 billion in the ABS classification 'financial derivative liabilities'. These are likely to be UK residents going short on Australian assets. Without the derivatives complication the UK figure would have been about $58 billion or around 13 per cent of the total foreign investment[23] which is similar to the stock figure and well above the UK's share in the world economy. So excluding derivatives the UK figure remains at a high level despite the UK's long signalled move towards lower company tax rates.

[23] These figures are taken from the ABS database cited in Table 2.

The foreign investment figures are very volatile even when measured over a five year period. If one large multinational shifts its retained earnings out of Australia, sells a subsidiary or suffers a loss (and so reduces its retained earnings) it may have the effect of causing a large fall in foreign investment over a particular year. We suspect there may have been instances of that sort in the case of Switzerland and the UAE.

The more remarkable thing about Table 2 (and indeed aspects of Table 1) is the prominence of the remaining five Asian countries with company tax rates much lower than the Australian rate. In each case their share of the flow (Table 2) is larger than the stock (Table 1) which means their present role among foreign investors exceeds their historic role.[24] As an example, China's share of foreign investment flows is 11.7 per cent which is much greater than the stock at 2.3 per cent. That in turn means that the large flow is dragging up the stock of investment. It also helps explain the small share of Chinese foreign investment in Australia; as an emerging economy its share of the world economy has been growing rapidly and its present level of annual investment in Australia is roughly commensurate with its share of the world economy.

If we want to look at total foreign investment then Table 2 presents the appropriate figures. However, these are contaminated by very large flows under the heading 'financial derivative liabilities'. For that reason Table 3 was constructed so as to exclude derivatives from the foreign investment figures. That adjustment gives us what we normally think of as foreign investment; direct investments which involve a controlling interest in an Australian venture and portfolio investments which involve the acquisition of securities but without a controlling influence.

[24] This year's stock is last year's stock plus this year's flow.

**Table 3: Foreign investment by source – Flow over 5 years excluding derivatives.**

| | Share of foreign investment % | National company tax rate % | Local company tax rate % |
|---|---|---|---|
| **US** | 35.40 | 35 | varies |
| **UK** | 7.07 | 20 | |
| **Belgium** | 11.40 | 33 | |
| **Japan** | 7.37 | 23.9 | varies |
| **Singapore** | 3.74 | 17 | |
| **Hong Kong** | 4.43 | 16.5 | |
| **China** | 5.69 | 25 | |
| **Luxembourg** | 0.14 | 21 | 6 to 12 |
| **Netherlands** | 2.64 | 25 | |
| **Switzerland** | -1.40 | 8.5 | |
| **United Arab Emirates** | -2.32 | 0 | 50+ on oil and gas |
| **South Korea** | -0.02 | 22 | 2 |
| **Malaysia** | 0.90 | 24 | |
| **Other** | 24.96 | | |
| **Total all countries** | 100.00 | | |

Sources: As for Table 2.

Table 3 shows a similar pattern to Table 2 but with a major difference in the UK which now has a strong share in Australia's foreign investment. Belgium has an unexpected strong presence among the foreign investors. We are not aware of major operations on the part of Belgian companies. Inspection of the fine data shows that Belgium's foreign investment is mainly portfolio investment and, as such, is largely inconspicuous. Singapore again features strongly. Switzerland, the UAE and Korea show negative foreign investment shares as a result of a contraction in foreign investment. We are not aware of any recent changes in their tax arrangements and note that from Table 1 they remain strong investors in Australia. Again the pattern among these countries does not support the simple Morrison thesis that we need cut company taxes to be competitive.

From Tables 1, 2 and 3 it seems that foreign investment flows are in the opposite direction to that suggested by the cut-company-tax lobby. Certainly Tables 1 to 3 do not show any evidence of the relationship being in the direction the cut-company-tax lobby might predict. While some countries, the US and Belgium, could be used in support of the cut company tax lobby, many other countries go in the opposite direction. The conflicting evidence cannot be used as support for arguments that foreign investment goes in the direction of lower company tax rates.

A different view of foreign investment is obtained by examining figures from the Foreign Investment Review Board (FIRB). Those are presented in Table 4 which shows foreign investment approvals by source country in 2014-15 and whether or not the countries have a lower company tax rate than the Australian rate. Note that these only include projects for which approval needs to be sought. Under the US-Australia trade and investment agreement the threshold for approval is much higher than for other countries while in the case of Chinese investment on the part of state-owned enterprises there are much lower reporting thresholds.[25] Generally also established foreign investors retain profits in Australia and are free to expand their businesses and none of that is included in the FIRB data.

**Table 4: Foreign investment approvals by country and home company tax rate.**

| | | $m | Number of projects assessed | Has lower tax rate? Y/N |
|---|---|---|---|---|
| **1** | China | 46,563 | 25,431 | Y |
| **2** | US | 25,093 | 412 | N |
| **3** | Singapore | 9,974 | 1,097 | Y |
| **4** | Japan | 8,658 | 152 | ? |
| **5** | Canada | 7,888 | 309 | Y |
| **6** | UK | 6,528 | 1,588 | Y |
| **7** | Malaysia | 5,137 | 2,236 | Y |
| **8** | Thailand | 3,437 | 80 | Y |
| **9** | Korea | 3,011 | 224 | Y |
| **10** | Hong Kong | 2,706 | 1,292 | Y |
| **11** | Germany | 2,328 | 174 | N |
| **12** | UAE | 1,826 | 38 | Y |
| **13** | Switzerland | 1,801 | 80 | Y |
| **14** | Netherlands | 1,691 | 91 | Y |
| **15** | NZ | 1,656 | 145 | Y |
| **16** | Brazil | 1,505 | 25 | N |
| **17** | France | 1,214 | 120 | N |
| **18** | Spain | 1,155 | 30 | Y |

Source: Foreign Investment Review Board (2015) *Annual Report*.

It is possible that the results in Table 4 are biased towards showing higher foreign investment levels from countries such as China which, as noted above, face greater reporting requirements especially in relation to their state-owned enterprises relative

[25] See FIRB (2016) *Australia's Foreign Investment Policy* at http://firb.gov.au/files/2015/09/Australias-Foreign-Investment-Policy-2016-2017.pdf

to the US which faces much higher thresholds for requiring approval because of the US-Australia trade and investment agreement. Another qualification is that the FIRB figures do not tell us whether the proposed investments took place or will take place. Nevertheless apart from the US and possibly Japan the top ten countries have lower company tax rates than Australia yet invest heavily in Australia. Indeed, by value 71 per cent of foreign investment applications come from countries with company tax rates lower than Australia’s rate and by number a large 97 per cent come from countries with company tax rates lower than Australia’s rate.

So far this paper has looked at foreign investment in the context of company taxes alone. However, the ultimate owners of capital are people who make decisions based on *all* the incentives that face them. Hence in so far as we think taxes influence decisions we need to look at how the ultimate owners of capital are influenced by not only the company tax rate but also the personal income tax rate and the interaction between the two. The next section considers those interactions and how the incentives to invest vary from country to country when both company and personal income taxes are examined.

# The role of dividend imputation

So far this paper has examined the proposition that company tax rates influence foreign investment. However, it is ultimately people who own wealth and how they allocate that wealth will depend on not just company taxes but other factors that may influence their returns. The role of personal income tax is the most critical factor we have not discussed. This section addresses the interplay of company and personal income taxation.

Table 5 presents the company tax rates found in OECD statistical tables which are different to the Deloitte figures referred to earlier. Where relevant the figures in Table 5 include the company taxes levied at the sub-national level. Hence the US rate is shown as 38.92 per cent which includes the national rate of 35 per cent and the average of the state company taxes which have the effect of increasing the total to 38.92 per cent. The data are presented in descending order so that the top of the table has the country with the highest company tax down to the country with the lowest. It is the figures in Table 5 that are often presented at face value without further qualification.

**Table 5: Company tax rates: OECD countries**

| Rank | Country | Company tax rate (%) |
|---|---|---|
| **1** | United States | 38.92 |
| **2** | France | 36.4 |
| **3** | Belgium | 33.99 |
| **4** | Germany | 30.18 |
| 5 | **Australia** | **30** |
| **6** | Mexico | 30 |
| **7** | Japan | 29.97 |
| **8** | Portugal | 29.5 |
| **9** | Luxembourg | 29.22 |
| **10** | Greece | 29 |
| **11** | New Zealand | 28 |
| **12** | Italy | 27.5 |
| **13** | Canada | 26.7 |
| **14** | Austria | 25 |
| **15** | Israel | 25 |
| **16** | Netherlands | 25 |
| **17** | Norway | 25 |
| **18** | Spain | 25 |
| **19** | Korea | 24.2 |
| **20** | Chile | 24 |
| **21** | Denmark | 22 |
| **22** | Slovak Republic | 22 |
| **23** | Sweden | 22 |
| **24** | Switzerland | 21.15 |
| **25** | Estonia | 20 |
| **26** | Finland | 20 |
| **27** | Iceland | 20 |
| **28** | Turkey | 20 |
| **29** | United Kingdom | 20 |
| **30** | Czech Republic | 19 |
| **31** | Hungary | 19 |
| **32** | Poland | 19 |
| **33** | Slovenia | 17 |
| **34** | Latvia | 15 |
| **35** | Ireland | 12.5 |

Source: OECD http://stats.oecd.org accessed 16 December 2016.

The figures in Table 5 show Australia has company tax rates that put it equal fifth (with Mexico) among the 35 OECD countries. Australia is well above some countries we like to compare ourselves with such as the UK. Even so, we should expect that even those most enthusiastic about cutting company taxes would concede that plus or minus five per cent should not make too much difference. On that basis we have to go down to the nineteenth ranked country, Korea, to find a country with a significantly lower company tax at 24.2 per cent. Other notable countries with significantly lower tax rates are Denmark, Sweden, Switzerland, the UK and Ireland.

While these figures are interesting they only tell part of the story. Investors in other countries face not only company tax but also personal tax on investment income. If anything is to influence the ultimate investor in different countries it will be the interaction of the company tax with the personal tax and their combined effect.

Normally it might be expected that companies pay company tax and if they pay dividends then those dividends will be taxed in the hands of the recipient at the recipient's tax rate. However, Australia has a dividend imputation system which gives shareholders credit for company tax deemed to have been paid on the individual's behalf. Australia's dividend imputation system is explained in an appendix. Australia is one of seven countries with a dividend imputation system and one of only four countries that gives full credit for company tax, with three other countries operating partial dividend imputation systems.[26] Table 6 uses the company tax rates and top personal income tax rates as well as the imputation rate where applicable to derive the total implied tax rate which is presented in the last column of Table 6. Our calculations ignore the temporary 'budget repair levy' which is due to expire on 30 June 2017. For countries like Australia which have two or more company tax rates we follow OECD practice and use the most common rate. Hence while there are two company tax rates in Australia at present (28.5 and 30 per cent)[27] we report the most common (30 per cent) in Table 6. Countries are then ranked in order of their combined tax on investments in companies.

[26] Full imputation systems operate in Australia, Chile, Mexico and New Zealand while partial imputation operates in Canada, Korea and the UK. The remaining 28 OECD countries do not operate a dividend imputation system.

[27] At the moment companies with turnovers up to $2 million are subject to a 28.5 per cent company tax. Legislation before the Senate would increase the threshold to $10 million in 2016-17 under a ten year plan and eventually, in 2026-27 all companies would pay just 25 per cent.

**Table 6: Deriving the implied total tax rate on company income**

| Rank | Country | Company tax rate (%) | Top marginal tax rate (%) | Imputation (%) | Implied total tax rate (%) |
|---|---|---|---|---|---|
| **1** | France | 36.4 | 44 | | 64.38 |
| **2** | Luxembourg | 29.22 | 40 | | 57.53 |
| **3** | Ireland | 12.5 | 51 | | 57.13 |
| **4** | United States | 38.92 | 28.52 | | 56.34 |
| **5** | Denmark | 22 | 42 | | 54.76 |
| **6** | Canada | 26.7 | 53.53 | 25.02 | 54.01 |
| **7** | Belgium | 33.99 | 27 | | 51.81 |
| **8** | Korea | 24.2 | 41.8 | 9.91 | 49.46 |
| **9** | Portugal | 29.5 | 28 | | 49.24 |
| **10** | Israel | 25 | 32 | | 49.00 |
| **11** | Germany | 30.18 | 26.38 | | 48.60 |
| **12** | Turkey | 20 | 35 | | 48.00 |
| **13** | Finland | 20 | 34 | | 47.20 |
| 14 | **Australia** | **30** | **47** | **30** | **47.00** |
| **15** | Norway | 25 | 28.75 | | 46.56 |
| **16** | Italy | 27.5 | 26 | | 46.35 |
| **17** | Sweden | 22 | 30 | | 45.40 |
| **18** | Japan | 29.97 | 20.32 | | 44.20 |
| **19** | Austria | 25 | 25 | | 43.75 |
| **20** | Netherlands | 25 | 25 | | 43.75 |
| **21** | UK | 20 | 37.5 | 10 | 43.33 |
| **22** | Spain | 25 | 23 | | 42.25 |
| **23** | Mexico | 30 | 42 | 30 | 42.00 |
| **24** | Chile | 24 | 40 | 24 | 40.00 |
| **25** | Switzerland | 21.15 | 21.14 | | 37.82 |
| **26** | Slovenia | 17 | 25 | | 37.75 |
| **27** | Greece | 29 | 10 | | 36.10 |
| **28** | Iceland | 20 | 20 | | 36.00 |
| **29** | Poland | 19 | 19 | | 34.39 |
| **30** | New Zealand | 28 | 33 | 28 | 33.00 |
| **31** | Czech Republic | 19 | 15 | | 31.15 |
| **32** | Hungary | 19 | 15 | | 31.15 |
| **33** | Latvia | 15 | 10 | | 23.50 |
| **34** | Slovakia | 22 | 0 | | 22.00 |
| **35** | Estonia | 20 | 0 | | 20.00 |

Source: OECD http://stats.oecd.org accessed 16 December 2016.

Table 6 is substantially different from Table 5. That illustrates how there may be a large difference between appearances if the company tax rate is considered in isolation. In Table 6 Australia appears as 14th among the OECD countries with 21 countries displaying lower overall tax rates. Of the 20 countries below Australia's implied total tax rate on company income nine of those are within five per cent of Australia's rate. The remaining 12 countries include NZ and Switzerland but otherwise would appear to be countries that would offer little competition to Australia. Of those six are former eastern bloc countries.

Table 6 shows that it is misleading to consider the company tax alone. For example Australia's company tax is 30 per cent compared with 20 per cent in the UK. However, Australia's return to investors in companies is 47 per cent compared with 43.33 per cent in the UK—a minor difference. If the UK reduces its company tax to 17 per cent the combined effect would still be 41.58 per cent and not all that different from the Australian rate. Table 6 also clearly demonstrates that Australia is roughly in the middle of the OECD pack when it comes to comparing the total tax impact on investors in companies.

Table 5 essentially shows the returns to the ultimate individual resident investors in the relevant countries.[28] Now the important thing is that since Australia's dividend imputation gives the individual credit for company tax paid, a change in the company tax will imply an equivalent change in the 'credit' so that the impact would have no effect on Australia's ranking in Table 6. That incidentally would also be the case in Mexico, Chile and New Zealand. But it cannot be stressed too highly that changing the company tax rate would have no impact on the incentives facing the ultimate investors in Australia.

# AUSTRALIANS MIGHT WANT TO HOLD SHARES IN COUNTRIES WITH LOW COMPANY TAX RATES

It might be objected that the figures in Table 6 ignore the possibility that investors in country A will purchase shares in country B and vice versa. Individual investors generally tend to have a strong home country bias which means they invest in companies resident in the same country. For example, it is well known that there is a strong 'home equity bias' as it is referred to in the economic literature. The home equity bias refers to the tendency for investors to bias investment towards their own

[28] Of course other taxpayers will be treated differently and, for example, super funds will pay a combined total tax rate of either zero or 15 per cent depending on whether they are in the draw-down or accumulation phase.

economy. A prominent textbook on international finance says 'there is clearly an equity home bias puzzle as it has become known. Investors around the globe are not fully availing themselves of international diversification opportunities; they hold fewer foreign securities than would be representative of the world portfolio'.[29] Australia demonstrates this very clearly. Australia accounts for about two per cent of the world economy and would be expected to issue about the same share of the world's financial assets/debt. However, most Australian fund holders would have only a small share of their portfolio in foreign assets. Australian industry super funds for example had $432 billion in funds under management at December 2015 and, of that, only 32 per cent were in international assets.[30] Australian super funds would hold 98 per cent of their funds in international assets if they were not biased towards Australian assets. The home country bias is even stronger among Australian households who appear to only hold four per cent of their financial wealth in those assets issued in the 'rest of world' as the ABS defines it.[31] That figure seems surprising given the large number of recent migrants in the Australian population and the business migration program that attempts to attract rich migrants.[32]

To be clear about this—residents in Australia are not attracted towards direct purchases of shares in foreign listed companies and neither are individual residents of other countries attracted to invest directly in Australian companies.

Companies are much more likely to invest overseas and, to that extent, Australian households hold foreign assets indirectly through their holdings in big Australian companies. BHP Billiton for example holds assets around the world so that BHP shareholders also hold assets around the world, albeit indirectly.

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[29] Levi MD (2005) *international Finance: Fourth Edition*, London: Routledge, p 335.

[30] APRA (2016) *Quarterly Superannuation Performance*, 23 February.

[31] Calculations from ABS (2016) *Australian National Accounts: Finance and Wealth, Sep 2016*, Cat no 5232.0 15 December.

[32] Australian Government, *Migration to Australia*, at http://www.australia.gov.au/information-and-services/immigration-and-visas/migration-to-australia accessed 4 January 2017.

# Conclusions

We have seen how cutting the company tax rate does nothing for the ultimate resident owners of Australian companies. Only foreign-owned companies would potentially benefit. That of course raises the question of whether or not it is worth proceeding anyhow. If it encourages foreign beneficiaries to invest more heavily and generate other benefits for the Australian economy then there may be a case for proceeding. The rest of the present paper looks at whether indeed lower company taxes are likely to generate higher foreign investment.

The evidence examined in this paper makes it clear that foreign investment over the course of Australia's history has not responded to changes in company tax rates as might be suggested by the Morrison thesis. We can also look at the source of Australian foreign investment and compare that with the rates in other countries. Again no systematic bias is evident and in a major contradiction to the Morrison thesis we find the United Arab Emirates has a zero company tax rate yet accounts for more foreign investment in Australia than might be suggested by its share in the world economy. In a sense the debate may be somewhat miscast in that it is not just company taxes that matter. The ultimate investor faces her own tax arrangements while also being affected by company tax arrangements.

Reflecting on the present debate about cutting the company tax rate Paul Keating, the architect of the dividend imputation system and at the time Treasurer, rhetorically asked why anyone would want to give such a gift to foreign investors. To say the least, Australia faces many more important spending priorities. The present Treasurer has tried to present foreign investment as a 'must have' to keep the company tax cuts proposal alive. But we doubt many Australians really understand that the company tax plan amounts to a very large gift to foreign owners.

# Appendix: Dividend imputation

There are a number of tax issues that are of major benefit to rich individuals but are very complex and therefore are little understood by those who do not have a direct interest. Dividend imputation is one of those complex tax mechanisms that very few understand. But the dividend imputation system is important in Australia and it is one of the measures that gives benefits to the well-off taxpayers worth approximately $35 billion per annum.[33] Despite that it seems the only ones who care enough to understand it are those who stand to benefit.

## What is 'dividend imputation'?

We can understand dividend imputation by considering what it was supposed to do. As Keating put it:

*Before I became Treasurer, company income in Australia was taxed twice: once at the company rate, at the time 46%, and then the dividends were taxed at the top personal rate of 60%. On $100 of company income, this left only $21 in the hands of the taxpayer!*

*In 1985, I changed the system completely and removed the double taxation of company income by introducing full dividend imputation. This meant that company income would only be taxed once. And this concession was reserved for Australian taxpayers.*

*People should understand that for Australian taxpayers, the company tax is broadly a withholding tax. The government collects it at the 30% rate on company income – and temporarily hangs onto it – before returning it to shareholders (including local superannuation funds) in the form of imputed credits.*[34]

That from Keating gives the intuition behind dividend imputation. The design of Australia's company and personal taxation systems means a company that earns a profit is liable to pay company tax. It may then pay a dividend to its shareholders who, in turn, are also liable to pay tax. There was concern that the final after-tax income of

[33] TAI calculations based on ATO (2016) *Taxation Statistics*.

[34] Keating PJ (2013) 'Dividend imputation and superannuation are worth fighting for', *Cuffelinks*, 21 February.

the shareholder might be a small proportion of the original company profit as a result of the two sets of taxes on the profits originating in the company.[35]

The dividend imputation system was designed to address those concerns and so makes refunds to individual taxpayers to reflect the tax paid by the company and imputed to the individual as owner. A numerical example helps here.

## Example: What would the effect of a company tax cut be?

We take Keating's example of a company which makes a profit of $100 and pays company tax at 30 per cent (or $30) leaving it with an after-tax return of $70. If the $70 is paid as dividends, then those dividends are again assessable in the hands of the domestic dividend recipient but under the imputation system credit is given for the tax already paid by the company.

To impute the company tax the $70 received as a dividend by an Australian taxpayer is 'grossed up' and taken to be the original $100 in working out the personal tax liability.[36] However, the company tax paid, the $30, is credited against the individual's tax liability. Hence if the shareholder is on a 47 per cent marginal tax rate, the tax on the 'grossed up' dividend of $100 is assessed as income generating a tax liability of $47. Now the assessed liability is reduced by the $30 already paid by the company. This is the 'franking credit' which is used to reduce the tax liability leaving $17 payable. The remaining amount payable will be determined by the taxpayer's marginal tax rate.

**I**f the shareholder's marginal income tax rate is lower than company tax rate the tax liability will be less than the credit so the tax office gives a cash refund to the individual. Hence some entities in Australia pay no tax but can get a cash credit for company tax imputed to them on their dividend income. Apart from individuals a prominent example is the case of super funds in the draw-down phase. Their tax liability on the grossed up $100 is zero so the entire franking credit of $30 is received as a cash payment.

A 'franking credit' represents the tax already paid by a company (in this case $30). It reduces the net liability which goes from $47 down to $17 payable by this individual to the tax office. That leaves $53 (=70-47+30) in the hands of the shareholder with the

[35] This should not be read as TAI support for dividend imputation.

[36] This example is easy but more generally the 'grossing up' is done by multiplying the franked dividend by 100 divided by 100 minimum the company tax rate of 30 in the present case.

tax office receiving $47, $30 from the company and $17 from the individual. The net effect in this example is as if the company paid no tax and the individual is taxed on the full amount at the appropriate marginal tax rate.

## Winners and losers

The important thing to note in this example is that the Australian shareholder is taxed at her own marginal rate. If the company tax rate were to be reduced to 25 per cent then, in the above example 70 would become 75 and 30 would become 25 which means the taxpayer’s net liability would be $22 which still leaves the same $53 in the hands of the taxpayer. Changes in the company tax rate do not alter the ultimate owner’s tax in this example.

The way the dividend imputation system works also means foreign entities cannot receive credit against any tax liability in Australia. Nor can they get around the design of dividend imputation by entering into arrangements to exchange franking credits with domestic taxpayers that may be able to use them.

The above assumes the resident taxpayer will receive a franking credit to offset some of their tax liability. However, if the taxpayer’s franking credits exceed their tax liability they are paid the balance in cash. Hence some entities in Australia pay no tax but can get a cash credit for company tax imputed to them on their dividend income. A prominent example is the case of super funds in the draw-down phase. Their tax liability on the grossed up $100 is zero so the entire franking credit of $30 is received as a cash payment.

We now work through the examples of two tax payers on different marginal tax rates, 47 and 37 per cent, and examine how their tax on dividends works now and how they might be affected if the company tax rate falls to 25 per cent.

**Table 7: three scenarios for dividend recipients and the changed company tax**

| | | 30% company tax | 25% company tax |
|---|---|---|---|
| Australian Company | Profit | $100 | $100 |
| | Company tax | $30 | $25 |
| | After tax return to shareholders | $70 | $75 |
| | | | |
| Aust shareholder | Taxable income | $100 | $100 |
| **47% marginal income tax** | Tax payable on income | $47 | $47 |
| | Franking credit | $30 | $25 |
| | Tax payable after franking credit | $17 | $22 |
| | ATO Receipts | **$47** | **$47** |
| **37% marginal income tax** | Tax payable on income | $37 | $37 |
| | Franking credit | $30 | $25 |
| | Tax payable after franking credit | $7 | $12 |
| | ATO receipts | **$37** | **$37** |
| | | | |
| Foreign shareholder | Tax payable (ATO receipts) | **$30** | **$25** |

Table 6 clearly shows that the Australian shareholders receive no benefit from the planned company tax cut, but the foreign shareholder receives a substantial benefit.