SHARING THE BENEFITS OF THE RESOURCES BOOM WITH THE SMALL INVESTOR

by

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Abstract

The author believes that the government should permit individual investors to earn up to $2,000 per annum tax free dividend income, over and above the $4,185 taxation threshold on earned income. Such a system would offer encouragement for small investors to participate directly in the resources boom, and would reflect reforms already implemented in the UK and Canada, and under Congressional review in the United States, with respect to dividend income on which corporate tax has already been paid.

If some such scheme is not introduced, it is highly improbable that Australia will be able to meet its target of 50% local equity in new resources projects which will require a doubling of equity capital raised annually from Australian equity markets to some $1 billion.

The Real Problem of the 1980's: A scarcity of Equity Capital

Contrary to widespread assertions made in the Media by both Politicians and editorial writers, it is highly improbable that the 1980's will prove to be a decade of unmitigated resources growth. Instead it appears that the resources boom will be made up of two distinct phases; a construction phase during the 1980's and an export phase beginning in the 1990's. This covers projects currently on the drawing board, such as Roxbury Downs, Jabiluka, Yeelirree, the LNG export phase of the North West Shelf and many others.

Instead, the 1980's promises to be a decade of investment during which huge sums of capital will be required to carry out the necessary mine development and install the infrastructure, plant and machinery.

The sums of capital required far outweight anything which we have yet witnessed in Australia. The Department of Industry and Commerce has conservatively estimated $33 Billion as currently awaiting development. This completely dwarfs the annual capital expenditure of some $1 Billion spent during the 1970's.

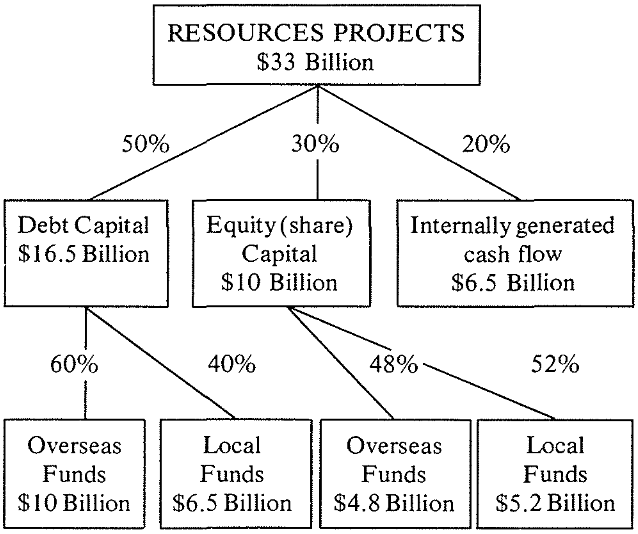
We will have to mobilise all the capital we can from both traditional and new sources. During the last twenty years, major Australian projects have been funded as follows,

Equity (or share) Capital	30%
Debt Capital	50%
Internally Generated Cash Flow	20%

Historically the local sharemarket has supplied 52% of the equity capital, with 48% being supplied from overseas. On this basis, we will have to generate $5.2 Billion in new equity investment through the sharemarket over the next five years.

In other words, the stock markets will be called upon to supply some $1 Billion per annum of new equity capital. (Table 1)

TABLE 1
Estimated Financing Requirements for Major New Projects



The level of new equity capital required is approximately double that which has been raised from our sharemarkets during the 1970's, even after adjusting for inflation. (Table 2)

TABLE 2
New Share Capital Raised by Listed Companies in Australia during the 1970's

	Manufac-turing $M	Finance and Property $M	Commerce $M	Mining and Other $M	Total $M
1969/70	122.9	36.7	8.9	288.4	456.8
1970/71	72.6	38.5	5.2	244.9	361.2
1971/72	31.1	42.3	12.3	169.3	255.0
1972/73	66.6	26.7	10.5	99.5	203.2
1973/74	82.9	119.9	20.6	42.4	265.6
1974/75	84.3	18.1	36.0	32.7	171.1
1975/76	115.0	68.5	57.5	91.3	332.3
1976/77	181.7	212.2	9.5	68.1	471.3
1977/78	142.3	100.9	41.9	64.5	349.6
1978/79	95.8	74.3	9.9	150.2	330.2
1979/80	172.5	95.9	29.3	215.7	513.4

Source: ABS

It is clear that all disincentives against equity investment in Resources projects will have to be removed, if the current goal of a minimum of 50% local equity is to be attained.

The conclusion is that we will have to double the volume of new equity raised from our capital markets. This can only be done if some major new incentive is given to individuals to invest in the future development of our country.

During the last five years, the small shareholder has continued his retreat from the market, and the number of shareholders in large publicly owned companies has typically declined by some 15%. (Table 3)

TABLE 3
Comparison of Numbers of Shareholders Eight Top Australian Public Companies

Company	1975	1977	1980
BHP	190,800	180,410	170,746
MIM	85,712	77,360	70,006
Hamersley	30,657	25,758	21,756
Myer	31,966	29,597	28,895
Bougainville	54,019	43,645	38,326
National Bank	21,619	22,158	22,751
Coles	53,371	49,826	44,756
Woolworths	50,387	46,655	41,016
Total shareholding all 8 companies	518,531	475,409	438,252
Percentage Reduction in number of shareholders since 1975	–	8.3%	15.4%

There can be no clearer case based on logic, personal equity or economic growth for arguing the elimination of disincentives presented by the double taxing of dividends.

Three Alternative Methods of Relief

The fact that the Government double taxes dividend income is incontestable. Corporate income is taxed at the full company income tax rate of 46%. Dividends paid from that same income are taxed to individual shareholders at the full progressive rates from 32% to 60%. This double taxation is a form of discrimination against both corporations and stockholders and represents an additional "cost of business", which ultimately will be borne by consumers in the form of increased costs. This double taxation is a burden on equity capital. Tax discrimination against equity capital is bad economic policy when business capital is in short supply for the enhancement of labour productivity and the growth of Australian industry.

Basically there are three methods through which relief from double taxation may be granted:

1) *Tax relief at the corporate level by allowing dividends as a tax deductible expense.*
2) *Tax relief at the stockholder level by complete elimination of tax on dividends.*
3) *Tax relief at the stockholder level by imputing corporate income to stockholders and allowing tax credit on income already paid by the company.*

1) Relief at the Corporate Level

This method will give tax relief at the corporate level by allowing corporations to deduct dividends paid when computing corporate taxable income. This method would be tantamount to imposing corporate tax only on retained earnings. Thus the company would treat dividends in exactly the same way as it currently treats interest. This method would remove the penalty against equity financing and disputed corporate profits would be taxed to shareholders in the same manner as income from any other source.

However, the fact that corporate income tax would apply only to retained earnings and not to distributed income would effectively amount to a differential tax on growing companies which need to retain all their profits for expansion. This penalty would act in a discriminate manner against small businesses which are too small to secure equity funds from the stock market.

In other words, the tax reliefs would go to companies that have already developed their earning capacity to the point where they can pay dividends without jeopardising their internal operatings. These large companies would have more funds to use to either increase their dividend payouts or for retained earnings, while smaller companies who are unable to pay dividends would not get any relief. Some closely held small companies might want to secure larger dividend payouts so as to avoid corporate tax on retained earnings. A stockholder whose personal marginal tax rate is lower than the 46% company rate would be better off to have all corporate earnings distributed and to pay tax at the personal marginal rate. Accordingly, stockholders in a small closely held company could withdraw corporate income and reinvest it in the same company if their individual tax rate was below the company tax rate.

2) Tax Relief at the Stockholder Level by Complete Elimination of Tax on Dividend

Under this form of relief from double taxation the Government would make dividends completely tax-exempt to the recipients instead of to the company. A direct consequence of this form of relief would be that the market price of dividends paying corporate stock would increase in comparison with alternative investment of the same risk.This increase in market price would have an important effect on corporate financing in a sense that fewer shares have to be sold to raise a given amount of capital. In other words, corporations could obtain new equity financing without depleting ownership to the extent that would otherwise be necessary. Companies would not have to pay out such a high percentage of their earnings in order to make their equity investments comparative with remainder of the market price.

If relief is given at stockholder level, the company tax remains the same regardless of the extent of dividend distribution or tax relief for stockholders. There is no tax cost associated with the distribution of dividends. Therefore, there is no pressure to pass the burden on to the consumer in the form of increased prices. Also higher stock prices would make equity financing more attractive and would lower the effective company "cost of capital". (Tax exemption of dividends on stock would increase the market price in much the same way as the tax exemption of certain corporate bonds increases the market price even though the yield is the same as that of a taxable bond).

3) Tax Relief at the Stockholder Level by imputing Corporate Income to Stockholders and Allowing a Tax Credit for Income Tax Already Paid by the Company

Under this method of relief from double tax, the corporate income is imputed to all company stockholders on a pro rata basis. The individual pays tax on the combined total of this personal and share of taxation income except that a tax credit is granted for a portion of the actual dividend received by the shareholder. The shareholder includes in his taxable income the amount of dividends paid and the amount of the tax credit. In the first instance a tax credit of one third of the dividend received is suggested. This is the scheme which is currently in use in Canada.

The UK system is based on a similar principle except that the amount of the tax credit allowed in the UK is equal to the tax which is actually being paid by the company, thereby ensuring that the volume of tax credits could never surpass the amount of company tax collected. The Canadian system has the advantage of simplicity and a minimum amount of bureaucracy. The tax credit to the shareholder should never result in a net refund to the taxpayer.

The above imputation system of tax credits to the shareholder was recommended in January, 1975 by the Asprey Committee for adoption in Australia. The Asprey Committee proposed a dividend tax credit in the range from 25% to 33% of the dividend received. The cost to revenue of such an inputation system on this basis would be minimal. The Government is able to control the rate of company income tax in the event that the lost revenue is required to be replaced.

Conclusion

The double taxing of dividends in the past has largely been responsible for the flight of the small investor from the stock market, because during periods of high interest rates the investor is able to achieve a higher yield on fixed income securities such as Government Bonds, Fixed Deposits and Corporation Debentures than the yield which he can reasonably expect from the share market. In addition, fixed income securities offer greater stability to earnings without the inherent risks which are an integral part of investment in the stock market. This phenomenon is manifested in the unprecedented high savings level as a percentage of household income. The absence of the small investor from the stock market has inhibited the growth of capital formation for use by private industry and has made it more difficult to finance capital intensive industrial projects.

The elimination of double taxation on dividends will enhance the attractiveness of equity investment relative to fixed income investment and therefore help to stimulate growth in the private sector.

Under the present legislation dividends received from one company to another are rebated under the provisions of Section 46 of the Income Tax Assessment Act. The overall effect of this rebating process is that no income tax is paid by one company on the receipt of the dividends from another. Thus, when costing the above proposal for granting tax rebates, revenue viewpoint, the only dividends to be considered are those received by the household sector; those dividends flowing between companies may be disregarded.

A similar scheme to recommendation (3) has already been adopted in France in 1965. Dividends continue to grow in France as the investor regards dividend yield as more significant than price earnings ratios in the market valuation of corporate stock.

Cost to Revenue

Over the past few years, the total value of dividends flowing annually to the household sector has been in the vicinity of $1,000 million. Also the average rate of taxation paid by the household sector has been approximately 20% of income. Therefore, if taxation of dividends were totally abandoned, the actual cost to revenue would be in the vicinity of $200 million, and even if it were assumed that the recipients of dividends have a higher than average income then the total revenue lost to the Government could not exceed approximately $250 million. This covers the whole field of both private and public companies. If the abovementioned taxation rebate scheme is adopted at the rate of a one half tax credit, the cost to revenue would be in the vicinity of $125M p.a. As mentioned above, a complete abandonment of taxation on dividends would represent a cost to revenue of no more than $250 million. In addition, the complete abandonment of taxation in dividends would represent a simplification of the complex taxation statute and therefore a significant reduction in the cost of assessing personal income.