

THE CASE AGAINST A WITHHOLDING TAX

HOW IT HELPS PUT AUSTRALIA IN THE RED



By *LOUISE WILSON*

A critical appraisal of Australia's external debt situation questions the role and relevance of the interest withholding tax

Australia has traditionally run a current account deficit and a capital account surplus its balance of payments. Until a decade ago, the growth in external indebtedness implied by such a trend was acceptable by world standards. Ten years ago, statistics on Australia's external debt were difficult to locate and aroused no debate. Now, the extent of our external indebtedness is a hot topic.

One aspect of the debate has focused on the trend towards debt, rather than equity, financing. Recent debate has also raised the interesting question of whether the current account deficit or the capital account surplus is the driving force in the balancing equation and the creation of external debt.

For example, Professor Heinz Arndt of the Australian National University has taken Professor John Pitchford, of the same university, to task over the latter's assumption that Australia's capital account surplus arises from long-term capital inflow for productive investment and creates the current account deficit. Professor Arndt appears to support domestic excess demand spilling over into imports as the driving force in our deteriorating current account deficit position. The resulting capital inflow, largely in

the form of borrowing rather than equity financing, compounds the current account deficit problem due to the outflow of interest payments.

Others, such as Professor Bowden and Ronald Bewley of the University of NSW, Ken Brewer of the Australian Bureau of Agricultural and Resource Economics and Garry White of Chase-AMP Bank, support the idea that Australia has a capital account surplus problem. In a global context, Professor Jeffrey Frankel of Harvard University has proposed that the capital accounts of major industrialised countries (including Australia) are now the driving force in balance of payments adjustment, due to the worldwide trend towards integration of financial markets in the 1980s.

Our policy-makers and most economic commentators appear to believe that Australia's current account deficit creates the capital account surplus. Tight monetary policy was introduced to squeeze out excessive consumer demand in

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the expectation that this would ultimately lead to reduced demand for imports and a reduction in the current account deficit. Several monthly balance-of-payments figures announced in 1990 have been greeted enthusiastically as evidence that the policy of high interest rates is appropriate and is beginning to work. But the current account deficit announced in May was the third-worst on record.

I do not believe that the policy prescription was correct in the first

place, nor do I believe that it is now working for the reasons commonly advanced. My theory is that Australia's external debt has increased dramatically in the past few years because it has been cheaper to borrow Australian dollars offshore than onshore. In this sense, I believe that the increasing capital account surplus has automatically created a larger current account deficit (and a higher level of external debt than would otherwise have occurred).

I first raised this idea in Decem-

ber 1988 in a presentation to the Joint Committee on Foreign Affairs, Defence and Trade in Canberra. At that time, there was insufficient statistical data available to support my assertion. With the passage of time, further data has become available. Let me review the significant developments affecting offshore borrowing in the last decade.

The scene was set when the currency was floated and exchange controls were removed in December 1983. Our connections with the international capital markets were thereby liberalised. The incentive to borrow from offshore was obvious when domestic interest rates were substantially higher than those offshore.

For a period, Australian borrowers continued their (previously limited) practice of borrowing in foreign currencies, although the flow of funds was greater after December 1983. However, the dramatic fall in the Australian dollar in 1985 badly burnt the fingers of many borrowers and led to the so-called "Swiss franc loans" litigation against major Australian banks.

Foreign currency loans have fallen out of favour among both Australian borrowers and lenders, unwilling to accept the risks involved. Nevertheless, borrowers continued to find the burden of Australian dollar interest rates onerous and were open to any scheme offering a cheaper source of funds.

The next step occurred when Australian entities lost their exemption from paying interest withholding tax. This initially happened in May 1983 but arrangements were significantly tightened from July 1, 1986. The existence of interest withholding tax creates a significant gap between the rates for onshore and offshore borrowing.

For a foreign currency, the offshore lender has no commercial reason to lend to Australia if liable for Australian withholding tax. He can achieve his full return by lending to a country which does not impose such a tax. International loan agreements usually specify that interest payments are adjusted for any local taxes. Therefore, the Australian borrower effectively has to pay the interest withholding tax as well as the interest if he borrows offshore in a foreign currency. (For a time, this led to a boom in business for certain banks able to offer tax-

Figure 1: Discrepancy between Onshore and Offshore Rates with Interest Withholding Tax — a Hypothetical Example for AUD

A.

Assume AUD domestic (bank bill) rate is 17% for 3 months

If borrow USD765,000 @ 8% for 92/360 days, interest = USD15,640

If sell USD, buy AUD @ 0.7650, receive AUD 1,000,000

If lend AUD 1,000,000 **onshore** @ 17% for 92/365 days, interest = AUD42,849.32

Therefore, receive in 92 days AUD1,042,849.32

Must repay to lender USD765,000 plus USD15,640 plus 10% Withholding Tax to Aust. Government (AUD equivalent of USD1,564)

Total = USD782,204

The forward rate required to make these two transactions equivalent is

$$\frac{782204}{1042849.32} \text{ or } .75006425664 \text{ or } .7501$$

B.

Equivalent Euromarket interest rate for AUD

If borrow USD765,000 @ 8% for 92/360 days, must repay USD780,640

If sell USD, buy AUD @ .7650

If lend AUD 1,000,000 **offshore** @ x% for 92/360 days

If sell AUD, buy USD780,640 at known forward rate of .7501, receive AUD1,040,714.57

$$\text{Therefore } 1,000,000 \times \frac{x}{100} \times \frac{92}{360} = 40,714.57$$

$$x = 15.93\% \text{ p.a.}$$

Discrepancy = 1.07% p.a.

Figure 2: Discrepancy between Onshore and Offshore Rates without Interest Withholding Tax — a Hypothetical Example for AUD

All the calculations are the same as in Figure 1, except that the USD required for repayment in "A" is USD780,640 (excluding withholding tax)

Therefore, the forward rate is $\frac{780640}{1042849.32}$ or 0.74856451936 or .7486

Substituting this forward rate in "B", one must receive AUD1,042,799.89

$$\text{Therefore } 1,000,000 \times \frac{x}{100} \times \frac{92}{360} = 42,799.89$$

$$x = 16.75\% \text{ p.a.}$$

Discrepancy = 0.25% p.a.

absorbed lines to Australian borrowers).

For Australian dollars, the situation is different. An offshore holder of Australian dollars willing to lend directly to an Australian domestic borrower has to absorb the withholding tax as there would otherwise be no incentive for the Australian borrower to use the offshore lender's funds. Therefore the offshore lender gets a lower return onshore than the nominal domestic rate. (He is willing to do this so long as there is a sufficient interest differential favouring Australian dollar investment over investment in alternative international markets to allow for the exchange risk of holding Australian dollars).

The workings of the example in Figure 1 show that if the three-month domestic rate is 17 per cent, the offshore lender to Australia can invest in Australian dollars offshore for the same term at 15.93 per cent and receive an equivalent return. (This gap is not entirely due to withholding tax—some is due to the 365-day or 360-day basis of the calculations performed in the two markets). This

feature needs to be borne in mind when reading the next paragraph.

The final step occurred on November 5, 1986. A mechanism for borrowing from offshore without paying withholding tax had existed for some years. This was the "widely-distributed bearer bonds" route, in practice available only to the larger, more creditworthy borrower. From November 5, 1986, it was officially permitted to issue these bearer bonds in Australian dollars. (Previously \$A-denominated bonds had been issued but all physical settlements were in a foreign currency equivalent, a relatively messy procedure in the international markets.)

From the offshore lender's perspective, he could now invest in Australian dollars in three ways:

- directly into Australia at, say, 17 per cent for three months less 10 per cent withholding tax;
- directly in the euro-\$A market offshore at, say, 15.93 per cent or better for three months; or
- directly in \$A-denominated bearer securities (issued not only by Australian borrowers but by many international issuers as well). Aus-

tralian borrowers with access to this market could offer interest rates on their paper below 16.75 per cent per annum (see Figure 2) and thereby obtain cheaper Australian dollars offshore than onshore.

In the early days of the offshore Australian-dollar securities market, it was an Australian borrower's market. As time went by, many more borrowers tried to tap the market. Some were international borrowers who found they could swap Australian dollars into a foreign currency at advantageous rates. Others were Australian borrowers (government and corporate) keen to lower their high cost of borrowing without incurring the exchange risk of borrowing in a foreign currency. A third category of borrowers was represented by Australian financial intermediaries, looking to borrow Australian dollars offshore more cheaply than onshore in order to increase the yield on their domestic lending portfolios.

These developments led to the market becoming an offshore lender's market through the normal forces of demand and supply. The offshore lender's willingness to accept the risks of exchange loss if the \$A declines or, more recently, the credit loss if the borrower defaults, has declined over time to the point where the offshore rate for Australian dollars now closely approximates the onshore rate. In other words, the differential created by interest withholding tax is increasingly an additional margin to the offshore lender rather than a saving for the Australian borrower. The incentive to obtain funds from offshore has now diminished and the accumulation of debt from offshore is less attractive. Nonetheless, it can still be cheaper than onshore borrowing. Some borrowers can still raise Australian dollars at approximately the bank bill rate from offshore, but they have to pay bank bills plus a margin to the lender onshore.

The figures in Tables 3a, 3b and 3c support these points. By 1988/9, offshore lenders to Australia preferred lending in Australian dollars offshore to lending direct into Australia (Table 3a). The proportion of \$A-denominated debt grew from 13 per cent of the total in 1982/3 to 38.2 per cent in 1988/9 (Table 3b). There has been a decline in the rate of growth in foreign currency-

Table 3a: Total Foreign Borrowing by Australia in \$Amil. (a)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Foreign currency (b)	31,030	36,794	54,144	70,876	78,760	79,598	84,662
AUD (b)							
— Domiciled abroad	2,094	3,704	5,866	9,067	11,708	17,791	30,796
— Domiciled in Aust.	2,543	3,564	6,916	12,108	14,439	19,630	21,588
Total borrowing	35,667	44,062	66,926	92,050	104,906	117,019	137,046

Table 3b: Currency Component of Total Foreign Borrowing

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Foreign currency	87.0%	83.5%	80.9%	77.0%	75.08%	68.0%	61.78%
AUD							
— Domiciled abroad	5.9%	8.4%	8.8%	9.85%	11.16%	15.2%	22.47%
— Domiciled in Aust.	7.1%	8.1%	10.3%	13.15%	13.76%	16.8%	15.75%
Total borrowing	100%	100%	100%	100%	100%	100%	100%

Table 3c: Currency Component of Total Foreign Borrowing

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Foreign currency	—	18.6%	47.2%	30.9%	11.1%	1.1%	6.4%
AUD							
— Domiciled abroad	—	76.9%	58.4%	54.6%	29.1%	52.0%	73.1%
— Domiciled in Aust.	—	40.1%	94.1%	75.1%	19.4%	36.0%	10.0%
Total borrowing	—	23.5%	51.9%	37.5%	13.9%	11.55%	17.1%

(a) Source: Australian Bureau of Statistics ("Foreign Investment Australia")

(b) Borrowing domiciled in Australia comprises securities issued in Australia and taken up by non-residents, as well as deposits held with Australian banks by non-residents. Borrowing domiciled abroad (both AUD and foreign currency) refers to all other borrowing from non-residents.

Table 4a: Interest & Dividend Withholding Tax Collections in Australia (AUD million) (a)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Interest	124	175	248	351	466	541	638	750
Dividend	134 (b)	130 (c)	155	209	172 (d)	125	97 (f)	99 (est)
Total	258	305	403	560	638	666 (e)	735	849 (est)

(a)Source: Aust Taxation Office Annual Reports and 1988-89 Budget papers.

(b)On 20 May 1983, the Treasurer broadened the collection base for interest withholding tax so that "Australian entities" and AIDC became liable to pay the tax when borrowing offshore. Bearer bonds remained exempt (if issued in foreign currency - no issues in AUD were permitted).

(c)In November 1983, the definition of bearer bonds was broadened, permitting greater scope to borrow in this form if eligible.

(d)From 1 July 1986, rollover of loans dated prior to May 1983 became liable to withholding tax. From 5 November 1986, bearer bonds could be issued offshore in Australian dollars. From 4 November 1986, State government and State and Federal semi-government authorities became liable for withholding tax.

(e)Income derived by non-residents on building society accounts was treated as interest not dividend income from 3 March 1988 and subject to interest withholding tax.

(f)Increase greater than expected because of higher than expected domestic interest rates and a fall in the AUD.

Table 4b: Annual Rate of Growth in Interest and Dividend Withholding Taxes (%)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Interest	n.a.	41.1	41.7	41.5	32.8	16.1	17.9	17.6
Dividend	n.a.	-3.0	19.2	34.8	-17.7	-27.3	-22.4	2.1
Total	n.a.	18.2	32.1	39.0	13.9	4.4	10.4	15.5

Table 4c: Estimates of Components of Interest Withholding Tax Collections (AUD million)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
From foreign currency borrowings (a)		98.1	139.8	197.6	241.0	325.3	343.9
From AUD							
– Domiciled Abroad (b)	3.2	4.5	8.0	13.3	15.3	21.9	45.3
– Domiciled in Aust (c)	23.2	26.0	56.9	106.8	113.5	169.0	222.1
Estimated Total	124.5	170.3	262.5	361.1	454.1	534.8	646.7
Actual Total	124	175	248	351	466	541	638

(a)Foreign currency interest rates as at June were obtained from the Reserve Bank Bulletin for US, UK, Germany and Japan. To the arithmetic average of the 4 rates for June - on - June was added a lending margin of 1.5% to produce interest rates of 7.9%, 7.6%, 7.3%, 6.8%, 5.9%, 5.4% and 5.6% for the years above. From the footnotes in Table 4a, it is assumed that 60% of all offshore borrowings were exempt from the tax in 1982/3, dropping to 50% until the end of 1985/6, then falling to 30% in 1986/7 and 20% in ensuing years. (To the extent that some foreign currency borrowing is in bearer bond form, some exemption is assumed).

(b)It is assumed that minimal withholding tax is collected from this source. An exemption rate of 90% is assumed. Withholding tax is applicable to the extent that borrowings are not raised in the "bearer-bond" markets. AUD interest rates assumptions were derived from the Reserve Bank Bulletin (90 day bank bills) as at June, averaged for June-on-June and 1% deducted to allow for the discrepancy between onshore and offshore rates. The resulting rates were 15.2%, 12.2%, 13.7%, 14.7%, 13.1%, 12.3% and 14.7% for the years above.

(c)AUD interest rates were calculated as in note (b). A margin of 1% was deducted to allow for the margin between bank deposits and bank bills. Therefore the rates were the same as in note (b). It is assumed that 40% of direct lending is exempt from the tax, for the various reasons that exemptions are available. From 1987/8, this exemption rate is assumed to fall to 30% because of note (e) in Table 4a.

nated debt (Table 3c) even though the theoretical climate for borrowing in foreign currency has been attractive in recent years (high Australian interest rates and rising Australian dollar).

It is of interest to consider the trends in the collection of interest withholding tax and to see whether the figures support my argument. Withholding tax collections are listed in Table 4a. The annual rate of growth in interest withholding tax collections shown in Table 4b bears little relationship to the annual rate of growth in Australia's total external debt (Table 3c).

Therefore I applied certain assumptions about the rate of collection of withholding tax to each component of Australia's external debt contained in Table 3a. The assumptions are "ball-park" figures based on the footnotes in Table 4a and rough approximations of my own experience with the international capital markets during the 1980s. Table 4c produces estimates of withholding tax collections close to the actuals listed in Table 4a.

From Table 4c, some interesting discussion points arise. It is obvious that the tax has become a significant revenue-raiser for the Federal Government, representing 0.9 per cent of total taxation revenue collections in 1987/88. However, using my line of argument and assumptions, in 1988/89 less than 35 per cent of this tax was actually paid by offshore lenders to Australia. (This conclusion is drawn from the tax paid on "AUD Domiciled in Australia"). The bulk (nearly 60 per cent) was paid on the foreign-currency component of the debt, and in this case it is the Australian borrower who has to gross up his interest payments so that the net payment received by the offshore lender is clear of Australian withholding tax.

In the main, it is the smaller Australian borrower who pays this tax — the larger, more credit-worthy, borrowers have been able to use the "bearer-bond" markets in various currencies, including Australian dollars, since bearer bonds are exempt from the tax.

The interest withholding tax is therefore a significant impost on the Australian community, rather than being primarily a tax on a foreign lender's profits on lending to Australia. There is a direct levy on Australians borrowing offshore in a

foreign currency and, in recent times, there has been an indirect levy on Australians borrowing offshore in Australian dollars. (The indirect levy exists to the extent that lenders to Australia in Australian dollars from the offshore markets are obtaining the benefit of an additional lending margin because of interest withholding tax, as mentioned earlier.)

I believe that the entire Australian community has also paid a price for the existence of this tax, in the form of unnecessarily high interest rates. The Australian business community has not been vocal on this point because:

■ the figures on withholding tax collections (like those on our external debt 10 years ago) are not readily available — the “out of sight, out of mind” syndrome;

■ it is generally the smaller borrower who pays the tax and complaints from small individuals are often overlooked;

■ to the extent that participants in the capital markets understand the impact of withholding tax, it suits many of them to retain it — capital markets or swaps experts look good before management and the board if they appear to be raising cheap money (management and the board usually do not have technical knowledge of this subject); and

■ most economic commentators and government advisers have not had the practical experience in international capital markets required to realise that this topic is an issue.

The conclusions I have drawn from Table 4c are not intended to support the view that the exchange rate should not have been floated, that exchange controls should not have been lifted, that bearer bonds should be liable for withholding tax or that bearer bonds issued in Australian dollars should not be permitted. Rather, they are intended to question the relevance of an interest withholding tax. Many other economies have never introduced, or have abandoned, this tax.

My overall argument leads to the conclusion that increasing domestic interest rates was not the appropriate policy for the past couple of years. It only exacerbated the balance of payments problem by encouraging increasingly hard-pressed borrowers to utilise any available route to interest-rate relief. The most obvious route was created by the govern-

ment itself through the withholding tax mechanism: access to cheaper Australian dollars offshore. The offshore demand to buy Australian dollars to lend to Australia drove up the currency and enabled consequently cheaper imports to flow into Australia, often at the expense of local production.

My view is that a relatively minor micro-economic adjustment (the removal of interest withholding tax) would have been a sufficient policy step for balance of payments purposes after November 1986, without the need to tighten monetary policy. (The issue of the 15 per cent dividend withholding tax is also relevant but outside the focus of this paper.) This would have avoided much of the current pain being experienced in the Australian community at all levels because of record high interest rates. It would also

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have avoided the rapid build-up in external debt to the point where, I believe, offshore lenders are increasingly reluctant to accept the risk of lending to Australia. We seem to be at a turning point in our ability to fund ourselves from offshore. New programs to issue commercial paper securities to investors offshore, particularly in Asia, continue to be announced, especially by government borrowers. However, some existing programs for reputable corporates cannot attract sufficient investors, particularly in Europe and the United States, and are being funded onshore by the Australian underwriters.

At this point, one can reflect on whether, given the obvious if sometimes unwise willingness of the inter-

national banking and investing community to lend to Australian borrowers in recent years, the total level of external debt would have risen as high without access to cheaper Australian dollars offshore. Would the same level of borrowings have been made in foreign currency instead? I think not. Could the Australian domestic market have supplied as many Australian dollars?

It is traditional for economists to argue that the demand for funds evident over the past few years could not have been supplied from within Australia and had to come from abroad. My response is that the level of demand was abnormally high and would have been lower without the inbuilt profit mechanism of the exchange-risk-free transactions described above. Perhaps \$15 billion of our current level of external debt would not exist without interest withholding tax. I estimate that it inflated our external debt by about \$10 billion in 1988/89 alone. Without the tax, much of what is now regarded as external debt would instead be recorded as domestic debt.

If the Australian dollar debt had been sourced within Australia, it is doubtful that as much of it would have been made available: banks arranging Australian dollar bearer debenture issues offshore did not have to accept the credit risk themselves as they would for most forms of Australian dollar lending within Australia. The logical consequence of this line of argument is that, similarly, domestic demand was switched into import consumption, also at a higher level than would have occurred without the tax.

To conclude, adjustment of our external account will occur — but not because our “excessive demand” for imports has been eliminated. Rather, I believe that the adjustment will depend on a reduction in the supply of funds to Australia.

Removal of interest withholding tax at this point will hasten the adjustment, as the incremental margin to offshore lenders (extra return on Australian currency and credit risk) will disappear. Business confidence and offshore confidence are fragile concepts and would be adversely affected by an unexpected policy move. Nevertheless, the impact of interest withholding tax on Australian business and the Australian economy needs to be reconsidered. □