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Dividend Imputation and the Australian Financial System: What do we know?

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DIVIDEND IMPUTATION AND THE AUSTRALIAN FINANCIAL SYSTEM: WHAT HAVE BEEN THE CONSEQUENCES?

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Overview: Approach of Paper

- Review evidence and theory inconclusive on imputation effects
- Contrast polar views (domestic segmentation v international integration)
  - Reality somewhere between – but where?
  - Use counterfactual of classical tax system (with same tax rates)
- Argue that view taken has implications across a wide range of issues
  - Not clear that participants in debates always consistent
- Examine effects of imputation for
  - Investor behaviour
  - Corporate behaviour – financial and real decisions
  - Structure and development of financial markets and intermediaries
  - Government tax consequences and policies

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Overview: Imputation cost-benefit

- Clear Benefits:
  - Corporate finance – financial stability, governance
  - Financial markets – less distortion than classical tax system
- Unclear
  - Investors – improved after tax rates of return?

  versus

  - Companies – lower cost of capital?
- Costs:
  - Government tax revenue
  - International Resource & Financial allocation decisions
    - But more reflecting tax differences across jurisdiction than imputation *per se*

Overview - Conclusions

- Net benefits versus classical tax system
  - Although other ways to avoid double tax of dividends
- Removing imputation would be disruptive
  - Financial asset prices
  - Investor strategies
  - Potential distributional consequences
- Much remains unknown about imputation’s effects
  - Because of global economy/tax interactions
    - They moderate but do not eliminate imputation benefits

Consequences of the Global Dimension

- Imputation removes dividend tax penalty of classical system
  - only for domestic investors in domestic companies
  - Equivalently – provides tax subsidy to them
- Research focus: is cost of capital reduced (the "γ" effect)?
  - Because domestic investors value domestic shares higher
  - But, does international financial integration overwhelm this effect?
- Answers:
  - Theory: unclear – impediments to tax arbitrage, diversification effects
  - Evidence: unclear – confounding factors (including capital gains tax and trading strategies)
  - Complications also include defining the relevant counterfactual

Consequences of the Global Dimension

- Those are important questions
  - Views on imputation effects assume particular answers
- If cost of capital reduced, more socially valuable investment (tax disincentive has been reduced)
  - But domestic investors have same rate of return after tax from existing assets (less cash, more franking credits) as without imputation
- If cost of capital not reduced, they have higher rate of return after tax than without imputation (due to tax credits)

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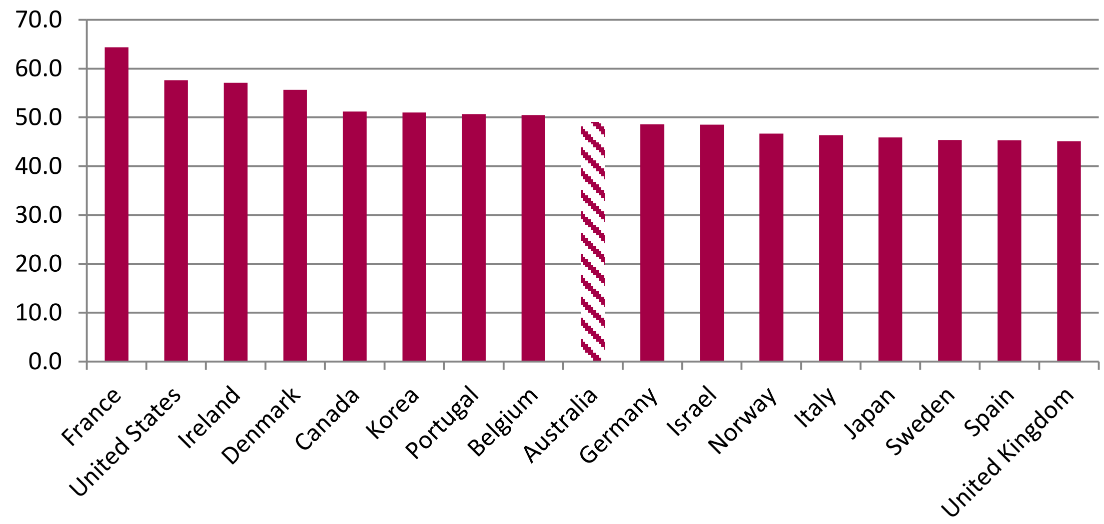
A spectrum of views – and implications

	Domestic Segmentation	?	International Integration
Determination of / level of domestic asset values	By domestic Investors – higher asset value	?	By international Investors - unchanged asset value
Cost of equity capital (v classical / overseas)	Lower (γ = 1)	?	Unaffected (γ = 0)
Physical investment	Higher (& jurisdiction bias)	?	Unaffected (no jurisdiction bias)
Dom. Investor benefit (v classical / overseas)	None – lower cash rate of return (dividend yield) but tax credits	?	Positive – same cash dividend plus tax credits
• Corporate Leverage • Dividend Payout • R&D etc tax breaks	Lower Higher Only benefit foreigners	? ? ?	Unaffected Maybe higher Effective

Imputation and Overall Tax rates

- Australian overall tax rate not high v OECD
  - Because of imputation
- **Figure uses top marginal personal tax rate**
- Much of Australian equity held by 0% or 15% tax rate investors
  - Would improve picture further

Overall Personal and Corporate tax rate on income distributed as dividends



Source: http://stats.oecd.org/index.aspx

Consequences of removing imputation

- Government tax revenue – what would be revenue neutral company tax rate under classical system
  - Lower
    - in absence of effects on real investment/activity, changes in corporate financial policy, estimate range of 15-20 per cent.
  - **Australia's overall tax rate on company income not high for domestic investors/companies (but for foreigners…)**
  - Different consequences for high v low tax rate investors
    - Same % change in after tax rate of return, but larger absolute reduction for lower tax rate group (since initially higher rate)

Consequences of removing imputation

- Domestic Investor Portfolios and Returns
  - Either initial capital gains losses or lower subsequent rates of return

	Domestic Segmentation	?	International Integration
Equity price decline & capital losses	Yes	?	No
Subsequent annual rate of return (if no change in dividend policy)	Unchanged – lower equity price, same cash return, no tax credits	?	Lower – no equity price change, same cash return, no tax credits
Composition of returns (due to co. div. policy)	Lower dividends, more capital gains	?	Maybe lower dividends, more capital gains
Allocation to foreign stocks	Initial effect: higher After - no tax bias	? ? ?	Initial effect: somewhat higher? After – no tax bias

Conclusion

- Main benefits of imputation relate to beneficial effects on company financial policy
- It has influenced financial market development and investment strategies
  - Any distorting effects are considerably less than those arising from concessional capital gains tax
- Complications and distortions from interaction with foreign tax systems would remain (albeit different) in absence of imputation