Report on The Commission's SMRIC Paper Presented at Modelling Workshop

by

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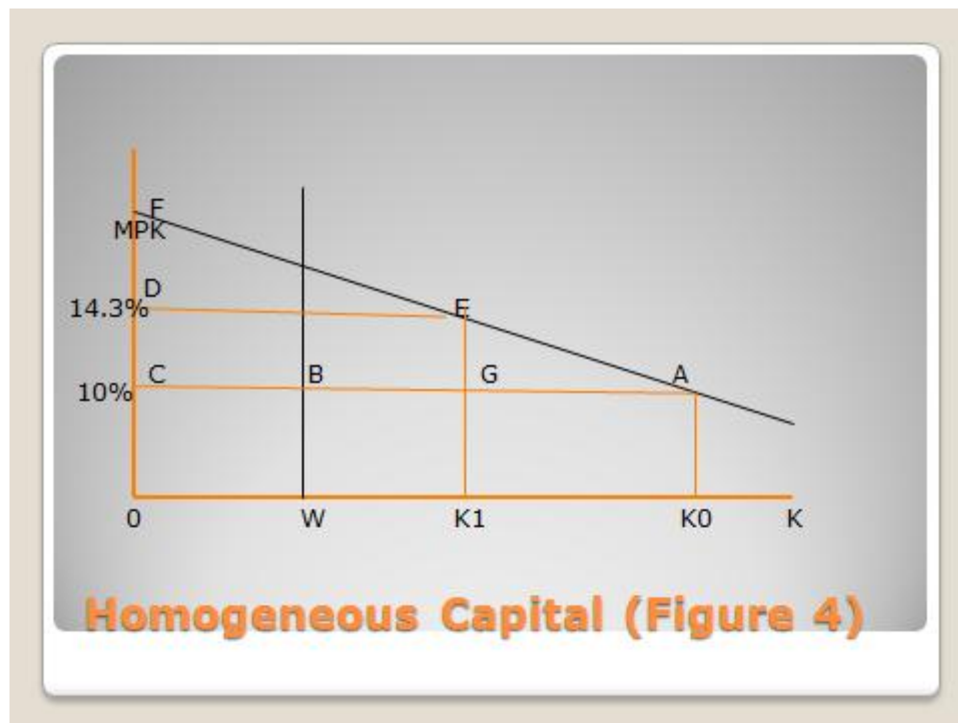
The likely effects of mutual recognition can be analysed with the aid of the following diagram taken from Matt Benge's paper:



Basically, this model assumes a perfectly elastic supply of foreign portfolio capital into Australia (or New Zealand for that matter) at the level CA in the absence of domestic corporate tax generating an overall capital stock K_0, or at the level DE in the presence of the domestic corporate tax, cutting back the overall supply of capital to the smaller amount, K_1. The distance OW shows the supply of domestic capital under either scenario and W K1 the quantity of foreign capital under the current corporate tax regime. Domestic investors receive franked dividends. For these investors there is no corporate tax as such. The withholding corporate tax is merely prepayment of personal tax and the amount of tax collected depends only on personal tax rates. Foreigners notionally pay corporate tax making up the rectangle of length BG and height DC but the incidence really falls on fixed (non-traded) factors such as domestic labour and land that suffer deadweight losses given by the triangle GAE since they miss out on the higher level of investment given by $0K_0$, rather than the actual level, 0K1.

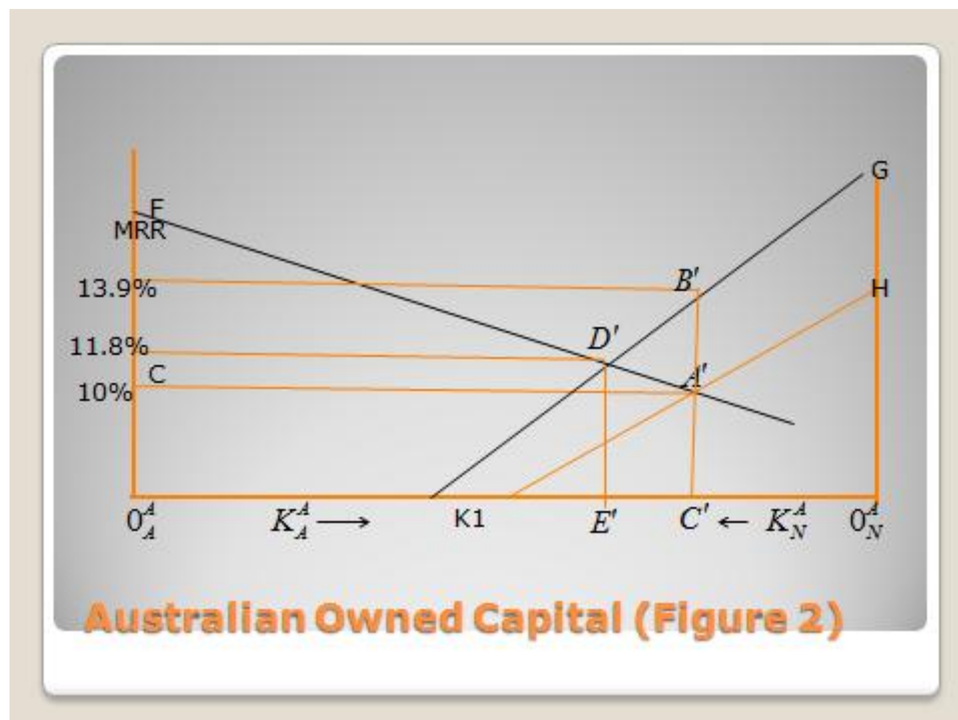
This scenario represents the standard price-taking "Small Country" assumption made by Trevor Swan in his Internal-External Balance paper. If this diagram represents Australia then New Zealand portfolio investment will make up a small proportion of the foreign investment shown, approximately 1%. Similarly, Australians will make portfolio investments in New Zealand, perhaps of slightly greater percentage magnitude. However, it would be quite misleading to suggest that mutual recognition of imputation credits would have any effect on the resulting equilibrium in either country indicating sizeable welfare gains.

If mutual recognition were to occur, New Zealand portfolio investment would no longer form (a small) part of foreign investment in Australia but would now receive imputation benefits and would effectively marginally expand the domestic quantity, $0K_1$ and contract the distance

K_1 - K_0, leaving the overall domestic level of investment at the same level, $0K_0$. Yes, by eliminating double-taxation of cross-border portfolio investment, I believe that there will be a he number of benefits, but they will not show up in the methodology adopted by the Productivity Commission study under discussion.
The critical variable in the Productivity Commission study is the elasticity of substitution between the trans-Tasman capital and the Rest of the World, $\sigma_{RoW}(r)$. If this is set at a very large number then there will be no aggregate net benefit to the two economies. Rather, there will be a sizeable transfer to New Zealand, as the Productivity Commission study shows. This is largely because the Australian economy is much larger than the New Zealand and the Australian taxpayer will need to recognise the large imputation credits that are generated by Australian investment in New Zealand. When dividends arising from this investment are repatriated to Australian investors, the Australian Government's tax revenue will be sizeably reduced, with negligible offsetting benefit to Australia, as the Productivity Commission study shows.

Hence, so far there are only transfers that do not benefit Australia and the way the study has been set up, i.e., its methodology, does not reveal the underlying efficiency benefits arising from mutual recognition.

One way of potentially progressing the existing methodology would be to acknowledge that direct investment by Australian companies in New Zealand is fundamentally different from portfolio investment and is far less substitutable with it. Such DFI relies on the specialized knowhow of Australian banks, supermarkets, etc. with respect to the Australian people with the New Zealand people being almost identical. On this view, there is underinvestment by Australian business in New Zealand due to double-taxation and there could be mutual gains to both New Zealand and Australian business if relieve could be provided for this double-taxation.



Australian Owned Capital (Figure 2)

The heterogeneous capital model implicitly assumed by the model is more plausible for Foreign Direct Investment by Australia. It is also more plausible to relax the Small Country Assumption that rules out efficiency gains from improving the operation of the imputation system. In fact, it is New Zealand that would be the major beneficially of a lower cost of capital for Australian FDI in New Zealand. In the figure (Figure 2), mutual recognition leads to expansion by Australian banks etc. by the distance, $E' - C'$.

Moreover, many of these investments are designed to minimize taxation within the context of a highly inefficient “classical” double-tax situation. That is, there is “thin capitalization” with excessive use of debt, and a huge reluctance to pay dividends. The problem in New Zealand is compounded by the absence of a capital gains tax. High leverage encourages the Lehman Brothers bank collapse problem due to excessive gearing and excessive cash retention encourages bad investment decisions. These distortions not only weaken the New Zealand economy and make another GFC more likely but also help to deprive it of corporate tax revenue. Hence, on a unilateral basis, New Zealand could consider providing some form of imputation credit benefit to Australian foreign investors on a unilateral basis.

However, this line of argument distinguishing between FDI and FPI is likely to further weaken the case for Australia to participate in mutual recognition. In fact, logically the shortfall in Australian tax revenue due to mutual recognition should be made up for by a higher Australian corporate tax rate. Since this a tax on Australian labour and fixed factors, the deadweight welfare costs could be quite high, further weakening the case for mutual recognition from Australia’s perspective.

Despite these arguments, I personally believe that the efficiency gains from mutual recognition are likely to be high, even from Australia’s more narrow perspective. However, to show thus would require more emphasis on the superiority of the imputation scheme in terms of discouraging excessive debt accumulation, retention of too much cash and poor investment decisions generally. There might also be benefits from the New Zealand Government coming to the party and finding ways to offset some of the additional costs being borne by Australian taxpayers.