

Australian government tax reform – or is it?

Economic Research note

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- The government's response to the Henry Tax Review has focused on increasing taxes on the resources sector and redistributing this income across all tax-paying companies, infrastructure and superannuation.
- The Resource Super Profits Tax (RSPT) will, however, link the fortunes of the Commonwealth budget even more to the commodity boom being driven by China and expose the government to a volume vs profits mismatch as long as the State taxes are reimbursed.
- A reduction in the company tax rate to 28%, more money for infrastructure in the resource states and an increase in the SGC to 12% should all be seen as positives.
- These policy announcements should, however, be seen only as an initial response to the Henry Review, with further developments likely either in next week's Budget and/or ahead of the expected H2 2010 election.

Overview

In its initial response to the Henry Tax Review¹ the Australian government has clearly decided that the commodity boom currently underway (due largely to a shift higher in demand from China) is a structural event that requires a large increase in the tax take from the resources sector to re-distribute some of the benefits to other parts of the economy, ie. how to manage the two-speed economy. The government has made it clear that this current resources boom needs to be "managed" better than the boom in the 1950s.

In macro-economic terms this makes sense, although the move does tend to tie Australia's economic future even more to the inevitable swings in the commodity price cycle. However, the proposed resources tax will make the Australian resources sector one of the most highly taxed globally and, it could be argued, that this threatens to "kill the goose that laid the golden egg."

In addition, as detailed below, while the revenue from the resources tax is set to be used to fund admirable changes (ie. a lower company tax, higher superannuation savings and more money for infrastructure) it should also be considered that other alternatives may also have been attractive.

First among these would have been to retire government net debt, freeing up significant revenue in each year's budget that would otherwise be used for interest payments. Once this net debt was brought back to zero, the government could have then used the revenue flow to establish a sovereign wealth fund that would invest the proceeds over the longer term (ie. the Norway model), in a way that could then benefit Australia when budget pressures become much more difficult in the decade ahead (ie. due to the cost of the aging population).

However, it does appear the government would prefer these extra funds to be managed by the individual through private savings rather than establishing a public savings scheme.

¹ Ken Henry, Secretary to the Treasury. "Australia's future tax system. Report to the Treasurer, December 2009.



The other factor to bear in mind with the government's response to the Henry Tax review is that this is likely to be only the initial move. Further policy announcements are likely in next Tuesday's 2010/11 Commonwealth Budget and ahead of the expected H2 2010 Federal election.

Indeed, as Ken Henry himself has indicated, the Henry Review should be viewed as similar in concept to the Asprey Tax Review of 1975. Many key recommendations of this review were not adopted initially, but helped set the agenda for many years to come, culminating with the introduction of the GST in 2000, some 25 years later.

Government response

As noted above, the major tax reform from the government is the introduction of a 40% Resource Super Profits Tax (RSPT) to apply from 1 July 2012. The RSPT of 40% will apply to profits from resource projects after allowing for extraction costs and recouping capital investment.

Prior to implementation, a government panel will work with the industry and the practicalities of implementation. One of the key aspects of this process is likely to be the definition of "super profits". The RSPT is expected to raise around \$A9bn in 2013/14.

The Commonwealth government will also reimburse the resource companies for the state-based royalties they will still be required to pay. This is in contrast to what the Henry Tax Review set out to achieve – simplicity and efficiency and will subject resource companies to additional red tape through the calculation of multiple taxes.

However, it is worth noting that the state-based royalty is a tax on volumes, while the new RSPT is a tax of profits, potentially opening up the government to a significant mismatch if commodity prices were ever to fall heavily, but with export volumes declining by a smaller amount.

The revenue flow from the RSPT will be partly used to:

- Cut the company tax rate from the current 30% to 28%. This will occur in two stages, with a reduction to 29% from 1 July 2013 and then to 28% from 1 July 2014. This will cost an estimated \$A2bn in 2013/14;
- The government has stated that they will look at reducing the company tax rate further (the Henry Review recommends 25%) "as revenue allows";
- However, for small businesses the company tax rate will be reduced in one hit to 28% from 1 July 2012. This will cost an estimated \$A300m in 2012/13;
- Small business will also be provided with other incentives, including the ability to write-off asset values more efficiently;
- Increase the superannuation guarantee charge from the current 9% of income to 12%. This increase will start in 2013/14 with a move to 9.25%. The SGC will then increase to 9.5% in 2014/15 and then by 0.5%pts each year to 12% by 2019/20. It is worth noting that this was not recommended by the Henry Tax Review.

- Supplement superannuation for low income workers and allow greater contributions for those over 50 that have relatively low superannuation balances; and
- Establish a State Infrastructure fund. This Fund will start with \$A700m in 2012/13 and is scheduled to grow over time.

Potential changes to come

The government has also stated that the initial response represents a "first wave" of reform. They also note that "in the coming months we will have more to say on a number of other areas considered by the review, especially making tax time simpler for everyday Australians, improving incentives to save and improving the governance and transparency of the tax system. This would represent a full second term agenda."

This would imply the government will have more to say on these factors ahead of the expected H2 2010 and will likely form a key part of the election campaign.

Recommendations in the "too hard" basket

Of the 138 recommendations in the Henry review, a number of them have been confined to the "too hard" basket. These include:

- Measures to increase the taxation of the family home;
- Require parents to work when the youngest child turns 4 and reductions to single income families and rent assistance;
- Changes to the system that would impact not-for-profit organisations;
- Reduce benefits to members of the defence forces;
- Reduce the capital gains tax discount;
- Reduce indexation of the aged pension;
- Remove the benefits of franking credits; and
- Change taxation of alcohol to a volumetric measure in the middle of a wine glut and when the industry is undergoing reform.

Implications for macro policy and economy

It is worth noting that the government's response to the Henry Tax Review is expected to be positive for the budget to the tune of \$A2.6bn in 2013/14, and greater in the years ahead. This is largely as a result of the revenue expected to flow from the RSPT.

The government's response is also expected (as detailed in the report) to have a net positive impact on GDP growth of 0.7% (compared to the baseline forecasts), with investment expected to be 2.1% higher, employment 0.1% stronger and real wages up 1.1%.

The implications for the two speed Australian economy are less clear. While the additional tax on the resources sector may see some changes to investment decisions, the extent of resources demand from Asia should continue to see strong growth and prosperity over coming years.

What is not clear is the impact the lower speed sectors of the Australian economy that will face headwinds of a stronger Australian dollar, higher interest rates, inflation pressures and competition for labour. The measures to reduce the corporate tax rate will help these sectors, but a two-speed Australian economy is likely to continue, but albeit with a more even distribution of wealth.

The market valuation of franking credits in a post Henry world

The government's response to the Henry Review will have a limited impact of the factors that were uncovered in recent research by CFS GAM on the market valuation of franking credits. Whilst the Henry review recommends some adjustments, the government has ruled out either changing the imputation system or removing the discount on capital gains. Under these conditions it will remain preferable for investors to receive capital gains rather than dividends and the market is likely to continue to factor the value of franking credits into share prices.

Chasing franking credits will not help investors after tax returns. The only impact will be the lower company tax which will reduce the franking credit from 42.9% to 38.9% of a fully franked dividend. This will further reduce the incentive to chase franking credits in an investment portfolio.

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