Company Taxation

ON February 13 the Prime Minister issued a statement on company taxation to the Australian press. This statement, which was published in the main Australian daily newspapers, attempts to disprove the criticism that the present level of taxation constitutes a heavy burden on companies, restricts enterprise and retards economic development.

The statement asserts that, in comparison with other sections of the community, companies have not been unfairly treated by the incidence of company tax and that economic progress has not been adversely affected. To sustain this contention the statement contains a statistical analysis of company income and taxation covering the period from the last financial year before the war, 1938-9 to 1946-7. This analysis affords a striking instance of the misuse of statistics. The statistics are, for the most part, irrelevant to the case which the statement attempts to sustain.

FIVE PROPOSITIONS

The conclusions of the statement rest on five main propositions:—

First, that the average tax paid per £ of company income over the war years approximated to 7/6 in the £, compared with 3/8 in the £ in 1938-9.

Second, that the total amount of income left to companies after payment of tax has never fallen below their total net income in 1938-9. The figures are:

1938-9	£73m.
1939-40	£84m.
1940-1	£83m.
1941-2	£73m.
1942-3	£78m.
1943-4	£88m.
1944-5	£78m.
1945-6	£80m.
1946-7	£87m.

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Third, that the total dividends paid by companies to shareholders resident in Australia have never fallen as low as the 1938-9 total and in 1946-7 were nearly 46% greater than in 1938-9. The figures are:

1938-9	£24m.
1939-40	£27m.
1940-1	£30m.
1941-2	£32m.
1942-3	£31m.
1943-4	£32m.
1944-5	£30m.
1945-6	£32m.
1946-7	£35m.

Fourth, that the total amount of undistributed profits remaining to companies after distribution of dividends has been well maintained over the war years and is now higher than in 1938-9. The figures are:

1938-9	£34m.
1939-40	£43m.
1940-1	£39m.
1941-2	£29m.
1942-3	£35m.
1943-4	£42m.
1944-5	£35m.
1945-6	£35m.
1946-7	£39m.

Fifth, that the proportion of the total of company income (before payment of tax) to the national income has remained practically constant at 11% since 1938-9.

1938-9	11.1%
1944-5	11.2%
1946-7	11.1%

Figures of the totals of net company income, company dividends and undistributed profits taken by themselves are, of course, meaningless. They assume significance only when they are related either to the amount of capital employed in earning them, or to the income of other sections of the community and of the nation as a whole.

PROFITS IN RELATION TO CAPITAL EMPLOYED

The total of company profits in England, for instance, is infinitely greater than in Australia, but this does not necessarily mean that English companies are better placed than Australian companies. In England the amount of capital invested in companies is many times that invested in Australia, and, naturally, the total amount of profit earned by those companies is far in excess of the profit earned by Australian companies. The Prime Minister's analysis completely leaves out of account the fact that since 1938-9 both the number of companies in Australia and the capital investment in them have greatly increased. While it is impossible to obtain accurate figures of the growth in the amount of capital employed by companies since the pre-war years, proof of the fact that there has been considerable development is afforded by the figures of the value of plant and equipment and of land and buildings employed in secondary industry. In 1938-9 there were 26,941 factories in Australia with plant and machinery valued at £143.7m. and land and buildings valued at £130.9m. By 1945-6 the number of factories had increased to 31,184, the value of plant and machinery to £185.5m., and the value of land and buildings to £184m. The numbers employed in secondary industry had grown from 565,000 in 1938-9 to

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745,000 in 1946-7. The sum total of wages paid had about doubled. It is, therefore, only to be expected that the total amount of income earned by companies would now be greater than in 1938-9. The significant factor in assessing the position of companies is not the total profit earned but the rate of profit, that is, the amount of profit obtained for each £ of capital invested. Figures published by the Commonwealth Bank show that the percentage rate of profit on shareholders' funds—after provision for income tax—declined from an average of 6.9% for the three pre-war years 1937-38-39 to an average of 6% for the three years 1944-45-46. This represents a reduction in the money rate of profit of over 13%.* The dividend rate expressed as a percentage of shareholders' funds fell away from a pre-war average of 5.4% to an average of 4.8% for the three years 1944-45-46.

In assessing the relative prosperity of companies between two points of time, figures of company earnings, without reference to capital employed, are as misleading and meaningless as would be total figures of wages and salaries paid in determining the prosperity of wage and salary earners. For instance, in 1938-9 total wages and salaries paid in Australia, including the pay and allowances of the defence forces, were £436m., in 1946-7 this had increased to £756m., a rise of over 73%. The average wage or salary earner would be the last to agree, however, that his income had increased by 73% since before the war. Just as company profit has no significance unless related to the amount of capital employed, so total figures of wages and salaries have no significance unless related to the numbers of wage and salary earners. The num-

* Provisional and incomplete figures published in the Commonwealth Bank Bulletin for December-January last, suggest that the level of company profits may have been higher in 1947 than in 1946. But the average of profits for the three years 1945-46-47 seems certain to be substantially lower than the average for the three pre-war years—probably by at least 10%.

ber of wage and salary earners has, of course, increased very considerably since before the war. Figures published by the Commonwealth Statistician show that the average wage rate per adult male had risen by 36% between 1938-9 and 1946-7—not by 73%. But even that is not the full story.

PROFITS IN RELATION TO PRICE INCREASES

In attempting to assess the improvement, or decline, in the welfare of wage-earners in general between two points of time, it is the accepted practice to consider not money wages but real wages, that is, the quantity of goods and services which the wage will purchase. This is affected by changes in the prices of the commodities and services on which the wage-earner spends his income. When average money wage rates of adult males are adjusted by the "C Series" index of retail prices, the rise in real wages since 1938-9 is revealed to be about 7%.

It would seem only logical to adopt a similar practice in the case of company earnings. The true value of income to a company, and of dividends to its shareholders, depends not on the money amount of the income or dividends, but on what they will purchase. When "C Series" price-index number is applied to the rate of company profits and dividends the decline between 1939 and 1946 is startling—nearly 40% in the case of profits, and about 35% in the case of dividends. Moreover, it should be noticed that the latter percentage applies before any account is taken of the great increase in rates of taxation since 1938-9 payable by shareholders on dividends received. It would not be over-estimating the position to suggest that when the three factors affecting shareholders' income — dividend rates, price rises and increased

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taxation — are brought into the reckoning, shareholders are, on the whole, probably less than half as well-off as before the war.*

Moreover, even the figures in the Prime Minister's statement, of *total* company income, dividends, and undistributed profits assume a very different aspect when they are related to price changes since 1938-9.

When these totals are expressed in terms of 1938-9 prices the figures become:

Year	Net Company Income		Dividends (to residents)		Undistributed Profits (accruing to residents)	
	Actual Figures £m	Adjusted for price changes £m	Actual Figures £m	Adjusted for price changes £m	Actual Figures £m	Adjusted for price changes £m
1938-9	73	73	24	24	34	34
1939-40	84	82	27	26	43	41
1940-1	83	74	30	28	39	35
1941-2	73	59	32	28	29	24
1942-3	78	57	31	25	35	26
1943-4	88	64	32	26	42	30
1944-5	78	56	30	24	35	25
1945-6	80	63	32	26	35	25
1946-7	87	62	35	28	39	28

NOTE: In the above table the figures of company income and undistributed profits have been adjusted by the Commonwealth Statistician's wholesale price-index and the figures of dividends by the "C Series" retail price-index, because dividends are mainly spent on consumption commodities. Neither of these indices are entirely satisfactory for the purpose for which they have been used, but they are probably the best available. The use of both indices has the effect of greatly understating the decrease in the real value of all three items. Particularly is this so in the case of undistributed profits, because the prices of new plant, equipment and buildings, and especially of imported machinery, have certainly risen considerably more than the increase of 45% since 1938-9 in the wholesale price-index. For instance, the index of the costs of building materials shows a rise of nearly 100% between 1938-9 and 1946-7. Prices of imported machinery are often double, and in some cases considerably more than double, the pre-war price for corresponding equipment. Reserves which may have been ample before the war are, therefore, dangerously inadequate under present circumstances.

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* The startling decline in the real value of the income of the investor in company shares is shown in the table on page 56.

The failure of the Prime Minister's statement to make any allowance for the much higher prices now ruling has the effect of giving a completely distorted picture of the relative position of companies now as compared with before the war.

PROFITS IN RELATION TO NATIONAL INCOME

As indicated above, the figures of total company earnings can be made to assume some meaning when their relationship to the national income is considered. The Prime Minister's statement does this in only one instance—namely, in the case of the total of company income before payment of tax. He shows that the proportion of total company income to the national income has remained practically constant since 1938-9—around about 11%—and that while national income has risen by 64%, taxable incomes of companies have increased in similar ratio. But the real item of significance to companies is not the gross income before payment of tax, but the net income, that is, what is left to them after payment of tax. This is admitted by the Prime Minister in the first part of his statement where he says, "The important factor is the relationship between the incomes remaining to companies after payment of taxation in the periods prior to, during and subsequent to the war." But the use of statistics in the latter part of the statement does not observe this principle. The proportion of net company income to total national income fell away from 9% in 1938-9 to 6.9% in 1946-7.

As a proportion of the national income over the same period, dividends to residents in Australia had fallen from 2.9% to 2.7%, undistributed profits accruing to residents from 4.2% to 3%, and undistributed profits and dividends payable overseas from 1.8% to 1%. By contrast, wages and salaries, as a proportion of the national income, had risen from 53.7% to 57.3%.

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PERCENTAGE INCREASES SINCE 1938-39

The following table comparing the percentage increase since 1938-9 in some of the main items pertaining to company income with the percentage increase in wages and salaries, is also indicative.

	1938-9. £m.	1946-7. £m.	% Increase
National Income	803	1265	57.5
Company Income (before tax)	89	140	57.3
Company Income (after tax)	73	87	19.1
Company Taxes	16	53	231.2
Dividends (Residents)	24	35	45.8
Undistributed Profits (Residents)	34	39	14.7
Wages and Salaries	432	725	67.8

It will be seen that while company income before payment of tax has increased by 57.3% since 1938-9, the total of wages and salaries had increased by 67.8%. Moreover, the increases in net company income (19.1%), undistributed profits to residents (14.7%), and in company tax (231.2%) are strikingly disproportionate to the rise of 57.5% in national income. It should also be noted that government expenditure of all kinds increased by 117% between 1938-9 and 1946-7.

The conclusion cannot be avoided that since the pre-war period there has been a deterioration in the position of companies both absolutely and relative to other sections of the community. This is in direct contradiction of the Prime Minister's main contention: "In the light of the sacrifices and demands made upon other sections of the community, I do not think that companies have been unfairly treated by the incidence of income taxation."

COMPANY TAXATION FROM STANDPOINT OF EQUITY

Severe taxes on company profits are bad from the standpoint both of equity and of economic effects.

Heavy taxation on companies is strongly advocated by those who see in it a means of "soaking the rich." But if that is the aim—shortsighted as it may be—it could be achieved much better by taxing the income of companies when it reaches the hands of the ultimate recipient—the shareholder. This is a far more certain way of achieving equality of sacrifice on the part of different sections of the community and different income grades than through the taxation of company earnings. Moreover, a company tax is highly inequitable as between different classes of investors. It discriminates unfairly against the equity shareholder in favour of the rentier class of investor, that is, those who invest their savings in such avenues as preference shares, gilt-edged securities and fixed deposits. In other words, it falls unfairly on the risk-taking investor, and, therefore, acts as a drag on enterprise and innovation. This is one of the chief reasons why a high rate of tax on company profits, such as obtains at the moment, is—contrary to the contention in the Prime Minister's statement—detrimental to economic progress and the rapid development of the resources of the nation. It tends to divert the stream of capital from adventurous and enterprising channels to comparatively safe investments.

ECONOMIC EFFECTS ON COMPANY TAXATION

Moreover, a large proportion of the additions and improvements to the industrial equipment of the nation is financed by means of company reserves—that is, by that part of the profit left over after dividends on their investment have been paid to shareholders. It can be proved statistically that somewhere around 50% of all new investment by companies in capital equipment is financed from this source. Spokesmen for the trade union movement have recently stated that the main responsibility for raising productive efficiency and increasing production rests with employers through the institution of up-to-date machinery and better methods of organisation.

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Such a view is completely inconsistent with an excessively hig rate of taxation on the earnings of companies, because the earnings provide one of the most important sources fron which improved mechanisation and equipment can b financed. It is to the community's interest that compani should be encouraged to save a large proportion of their earn ings and to use these savings for the installation of new an more efficient capital equipment.

Reserves set aside out of profits made in good times als serve an important function in enabling businesses to weathe successfully the wintry blasts of economic recession or depres sion. In times such as these, companies possessing good re serves are able to maintain their pay-rolls at levels whicl would not otherwise be possible. Provided business saving are ample in amount and properly used, private enterprise ca do much to cushion the effects of depression on wage an salary earners, and can contribute in a substantial measure t the maintenance of employment under adverse economic con ditions. This subject is one which should receive much mor study, both by governments and the business community. Th argument that, in times of full employment and high turn overs, businesses should be encouraged to accumulate strong financial reserves has many points of similarity with the well accepted economic principle that governments should budge for a surplus when economic conditions are favourable.

Company reserves also provide a smooth and effective method for the financing of business expansion. Apart from major capital projects, most sound businesses are constantly in process of gradual development through additions and improvements to their capital equipment. This process, which is of course beneficial to the community, is greatly encouraged where earnings are sufficient to permit companies to put aside adequate sums to reserves. It would be, to say the least, highly inconvenient for a company to go to the capital market every time it contemplated some modernisation or development of its productive assets.

The effect of the heavy taxation on companies over the war years has led to a greater proportion of profits being paid away in dividends in an endeavour to maintain the shareholder's return, and a smaller proportion being retained in business for capital improvement and for other purposes. This trend, if maintained, must be of necessity detrimental to the best interests of the community, which lie in the direction of a high rate of replacement, improvement and expansion of the nation's productive capacity. The fundamental objective in taxing company profits should be to ensure that the greatest possible encouragement, or the least possible discouragement, is given to the re-investment of earnings for the purpose of achieving more efficient methods of production. The present scale and method of taxation are directly contrary to this objective.

The rate of material progress can be speeded up and the standards of life of the community rapidly lifted only through the provision of an increasing range and volume of efficient productive equipment. On the assumption that a good part of total investment will for many years to come depend upon the activities of private enterprise, and if this investment is in turn, to a large degree determined by that part of profits "ploughed back" and re-invested in industry in new and better forms of capital equipment, it would seem the merest common sense to permit companies to earn a reasonably high rate of return on the capital employed.

In Australia far too much of economic and political thinking seems to be based on a false belief in the incompatibility of good profits and good wages. The truth is just the opposite. Good profits are necessary to a high and rising level of wages, and a high and rising level of wages is necessary to good profits.

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EFFECT OF INCREASED TAXATION AND PRICE CHANGES ON THE INCOME OF THE INVESTOR IN COMPANY SHARES— 1939 AND 1947

Example	Income for Year Ended 30/6/39		Income for Year Ended 30/6/47	
1. Personal Exertion	£,1000		£1,000	
Company Dividends	300		300	
		£1,300		£1,300
Less Tax		99		358
Net Income		1,201		942
Net Income Adjusted for Price Changes		1,201		628
2. Personal Exertion	£3,000		£3,000	
Company Dividends	1,000		1,000	
		£4,000		£4,000
Less Tax		799		2,133
Net Income		3,201		1,867
Net Income Adjusted for Price Changes		3,201		1,245
3. Personal Exertion	Nil		Nil	
Company Dividends	£500		£500	
		£500		£500
Less Tax		7		80
Net Income		493		420
Net Income Adjusted for Price Changes		493		280
4. Personal Exertion	Nil		Nil	
Company Dividends	£1,000		£1,000	
		£1,000		£1,000
Less Tax		18		223
Net Income		982		777
Net Income Adjusted for Price Changes		982		518
5. Personal Exertion	Nil		Nil	
Company Dividends	£3,000		£3,000	
		£3,000		£3,000
Less Tax		341		1,565
Net Income		2,659		1,435
Net Income Adjusted for Price Changes		2,659		957

NOTES:

1. In 1939, Federal tax payable on company dividends in the hands of the shareholder was subject to a rebate of 2/- in the £ representing tax already paid by the company. Except on the very high income ranges, this had the effect of completely eliminating Federal tax on company dividends received by the shareholder. This rebate was abolished during the war and has not been re-introduced. Company income is therefore now taxable in the hands of both the company and of the shareholder.
2. In 1939, no ordinary State tax was payable on dividends received by shareholders, but dividends were subject to State Special and Unemployment Relief Tax.
3. To allow for the effect of higher prices on the real value of the income remaining to the recipient after payment of tax, net incomes in 1947 have been reduced by one-third.
4. Calculations have been made on the basis of a man, wife and two dependent children.