Boardroom Discussion 23 June 2016: Corporate Tax Cuts.

An overview

Mike Callaghan

The boardroom discussion of corporate tax cuts held on 23 June 2016 was a very valuable exercise. Given the cross section of participants, with many previously expressing differing views on the topic, it is not surprising that the event did not conclude with unanimous agreement on the merits or otherwise of the Government's proposal for a phased reduction in Australia's corporate tax rate. But against the background of the many sweeping claims and controversy that has dominated the coverage of this issue, and which has no doubt confused the public, the boardroom discussion did help clarify some of the key issues that should be the focus of attention.

The discussion largely concentrated on the impact of a reduction in the company tax rate on encouraging foreign investment in Australia and in turn the impact of this investment on activity and national income. This is relevant because one of the popular criticisms of reducing the company tax rate is that because of Australia's imputation arrangements, the main benefit will go to foreign investors, with the implication that this is undesirable or wasted. But the boardroom discussion revolved around the acknowledgement that Australia needed to attract and maintain foreign investment and the issue was the priority to be placed on improving pre-tax returns through broader economic reforms or increasing the post-tax return for foreign investors via lower company tax, or both.

There was also recognition during the discussion that imputation does not mean that reducing the company tax rate will have no impact on Australian companies. If Australian companies pay less tax, they will have more to reinvest where profits are not paid to shareholders. It was evident from the discussion that the impact of a reduction in the company tax rate on domestic investment needs to be clarified. There have been a number of claims that a company tax cut will result in little change in domestic investment. However it was pointed out during the boardroom discussion that retained earnings are an important source of financing for many Australian companies.

There was agreement that reducing Australia's company tax rate will likely result in increased foreign investment and in turn economic activity – that is increased GDP. The area of dispute was the impact of this increased investment on national income. One concern expressed was whether Australia could absorb a large increase in foreign capital, particularly if the economy was close to full employment. While foreign investors will pay higher wages to attract workers, it was noted by some that this was not good for everyone. Domestic firms will face higher wages and costs which will lead to lower returns to domestic shareholders who get no direct gain from the company tax cut where they receive franked dividends. In reply to these concerns, the point was made that Australia does have substantial levels of under-employment and there is scope, with appropriate policies, to increase labour force participation and labour supply through higher migration, as well as improving the flexibility of the labour market.

In many respects, this is the key area that needs to be the focus of attention in the debate over cutting company tax, namely the impact it will have on investment, wages and incomes. Different assumptions regarding the substitution between labour and capital is a major reason for various models producing differing results of the impact on incomes of a cut in the company rate. This issue also goes to the key rationale behind the Government's proposal, namely that capital deepening through increased investment is an important component in lifting productivity and the most efficient way of deepening the capital stock for a small open economy is to encourage increased foreign investment.

As noted previously, one aspect of the discussion was on whether the emphasis for attracting additional foreign investment should be on raising the pre-tax return on this investment through such measures as a better educated and skilled workforce, more efficient infrastructure and so on. Although the point was raised that many of these reforms will require increased investment. Advocates for reducing the company tax rate readily agreed that it was not a silver bullet in lifting Australia's economic performance and a holistic package of reforms was required, although this included improving the competitiveness of Australia's company tax rate. In this context it was observed that Australia could not ignore that corporate tax rates are being reduced around the world, that capital was becoming increasingly mobile and Australia could no longer primarily rely on its resource endowments in order to attract investment.

The phased nature of the proposed reduction in the company tax rate was debated. One advantage of the phasing was that it would reduce the windfall aspect of reducing the tax rate on existing foreign investments. It was noted that the phasing would make Australia more attractive to the next round of investment and may encourage additional activity in anticipation of the cut in rates. However a key to this impact was investor certainty in the political process and whether the company tax reduction, particularly for large companies, will eventuate. The view was expressed, however, that if there is concern that it takes many years for the benefits of the reduction in taxes to eventuate, then the response should be to bring forward the cuts. It was also noted that the largest economic benefits will come from the reduction in the rate for large companies, however the phasing focuses on first reducing the rate for small companies.

Another area highlighted in the discussion was the need to clarify how the corporate tax cut will be funded. Part of the tax cut will be self-funding through a rise in activity and an increase in other taxes. In addition, there will be some reduction in profit shifting, although the magnitude of this response was questioned and this needs to be clarified. However even allowing for these factors, the reduction in company taxes will need to be funded through either reduced government spending or a rise in other taxes. The modelling on the tax cuts released by the Government has three funding assumptions – a lump sum tax, a rise in personal income taxes or a reduction in government spending/waste. However the Government did not specify how the tax cut will be funded beyond the forward estimates and the implication is that it will be through bracket-creep. Some participants indicated that there is limited scope for tax reform and the priority should be on changes to other taxes rather than cutting the company tax rate. The discussion suggested that reducing the company tax rate cannot be considered in isolation from other tax changes and there will be a need to consider the efficiency of all taxes, including the possibility of increasing indirect taxes.

A final point raised during the discussions was the role of models in assessing the benefit of a cut in taxes. It was noted that there is a tendency to rely on the results of modelling to 'justify' whether a tax change is worthwhile. This requires a lot a faith in the models and can be confusing when there are competing modelling results. It was recognised that the models are valuable in helping to articulate assumptions and to assess the relationships between different assumptions, but ultimately policy decisions require analysis and judgement