HOUSE OF REPRESENTATIVES

STANDING COMMITTEE ON TAX AND REVENUE

Taxpayer engagement with the tax system

(Public)

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SYDNEY

Australian Taxpayers' Alliance (ATA) – Reply to Questions on Notice

The following is a response to questions and comments put to the ATA by Terri Butler MP (Labor) providing clarification in particular, on our positions in relation to cutting the corporate tax rate, Australia's dividend imputation system and Ms. Butler's concerns about the connection between the two.

We refer in particular to the following comments:

"The chair asked you about tax rates, and you have particularly focused on corporate tax rates. But if our corporate tax rates were to be lowered, then the shortfall would just be made up from domestic income taxpayers, wouldn't it, because of dividend imputation? So wouldn't it be the case that the only people who would really benefit from a lower corporate tax rate would be foreign companies?"

"If franking credits aren't given out, then people will be able to claim less of a franking credit when they work out their income tax and they'll just pay more income tax. Effectively, it's no net change for the individual through the end user."

"We had record earnings last year in corporate Australia, but that hasn't led to more investment. In fact, the private sector capex has been tumbling through the floor."

"You've got record earnings, low capex, low reinvestment of profits back into the business, record payments of dividends to shareholders and companies that feel under pressure to pay dividends to shareholders in order to keep their share price up: why would reducing corporate tax rates change any of that?"

You lower the cost of business activity, profits go up, which means you can pay more out in dividends to shareholders. I'm giving you what is actually happening, not what you think the theory is. We just need

to look at the last 12 months to see that, when companies make more money because costs go down—and the same would apply if taxes go down—Australian firms are not reinvesting in the business. It's not creating new jobs. The money is going out into shareholders' pockets, which is great if you're a shareholder but not really a very good argument for taking revenue out of public hands and putting it into private hands, because it doesn't seem to lead to much improvement in living standards, security or job prospects for ordinary Australians.

Dividend Imputation & Corporate tax rate cut

We accept that if the corporate tax rate were lowered, it would mean less franking credits for shareholders, but would also lower the costs for the business.

This leads to one of two potential outcomes: either the business invests more in the business through capital expenditure, new ventures – creating new jobs or more work for existing workers in the process. Alternatively, it will lead to increased returns through shareholders through boosted dividends.

When the latter options is favoured after strong corporate profits are generated, this is a reflection of low predicted future profitability of the business relative to the current profits. This issue can be ameliorated by accompanying future corporate tax cuts with comprehensive deregulation and red tape/cost minimisation reforms which will incentivise re-investment in the business. A business will ultimately invest more in itself when the regulatory environment connotes that this will enhance long-term profitability. This in turn leads to more jobs and economic stimulation. An example of regulations which would increase the likelihood of corporate taxes simply resulting in greater shareholder dividends, is the introduction of new taxes which discourage the use of these funds for investment and thereby simply incentivise increased shareholder dividends. It is important for policy-makers to be cogent of this reality when considering tax reform or tax hikes in response to a tax cut elsewhere.

The reluctance of businesses to do so despite recording high corporate profits (in the past) is the result of a perception that returns from that reinvestment would be outweighed by the benefits of boosting share value by enhancing dividends. The fact that this has happened in the past in no way predicts that it will continue in the future as profitable and confident businesses have a self-interest in long-term profitability.

Having said this, increased dividends for shareholders is not a bad thing and benefits ordinary Australians.

Most Australians hold shares in large, publicly listed companies through their superannuation accounts and a large contingent or shareholders are mum and pop investors. Putting more money in the hands of ordinary Australians is beneficial as it is likely to flow back into the economy through increased spending and improvement in the living standards of these shareholders. Increased dividends and share value will also encourage future investment in the Australian economy, including market confidence in the profitability and viability of Australian businesses. Increased dividends are a function of successful investment and shareholders receiving a reward for taking the risk inherent in any investment should not be viewed as a negative outcome.

Foreign companies and corporate tax rate cuts

We accept that foreign companies stand to benefit the most from a corporate tax rate cut given our dividend imputation system. However, this is not a bad thing at all.

The purpose of maintaining a competitive corporate tax rate relative to our trading competitors is that it ensures that foreign investment can be attracted and is incentivised.

The country of Ireland has experienced substantial economic benefits including investment and job creation, even relative to its European Union counterparts because it has created a favourable tax environment to attract foreign companies which have hence used Ireland as a base for their European operations – ultimately resulting in a flow of wealth, investment and job creation to Ireland.[1] India is likely to cut its corporate tax rate significantly for the same reason.[2] Australia currently has one of the highest corporate tax rates in the OECD, even relative to other developed nations. It is advisable for us to follow the lead of France, the U.S and other countries by cutting our substantial rate to incentivise foreign investment further.

We note recent concerns about foreign companies not paying their fair share due to accounting strategies and tax loopholes. We therefore note that strategically phasing out certain deductions and exemptions whilst reducing the corporate tax rate simultaneously, is a far more ideal outcome than maintaining the status quo as it provides a desirable middle ground which combines both a 'carrot' and 'stick' approach to encouraging foreign investment whilst simultaneously connoting tax compliance and increased revenue from this investment. Increased foreign investment will therefore also likely result in increased government revenue despite the cut to the corporate tax rate.

Additional benefits to cutting the corporate tax rate

In addition, please find enclosed the following research commissioned by the ATA on the desirability of a corporate tax rate cut. The original document is attached as supplementary material to the e-mail containing this response.

The Government should cut Company tax to 20% over 5 Years

The Australian Government should announce a plan for phased cuts to the headline Company tax rate from 30 per cent to 20 per cent in 5 years. It should then set a medium-term aspiration to reduce the rate further, to be one of the most competitive in the OECD (the rate in Ireland, for example, is currently 12.5 per cent).

This kind of phased reduction in the rate has been the norm in other economies making substantial cuts to corporate tax rates. It serves two purposes:

1. It reduces the immediate prospect of an impact on the public finances. The early reductions in corporate income tax rates will increase the size of the corporate tax base, mitigating the revenue impact before the later cuts are made.
2. Many of the benefits of later cuts in Corporation Tax will occur early. The earlier rate cuts establish the plan's credibility and firms invest in anticipation of lower rates on the long-run returns on those investments.

This recommendation is more ambitious than the call for a cut to 25 per cent in the Australia's Future Tax System report in 2009, which also recommended various structural reforms (The Treasury, 2010), but reflects continuing cuts in other countries and Australia having fallen further behind the international norm since then. In the longer run, there is a strong case for deeper strategic reforms to the structure of corporate tax. The current corporate tax base is not expected to last forever and it creates harmful distortions.[3] In the meantime, however, all the problems with conventional corporate taxes are exacerbated by high rates and would be lessened by the adoption of a lower, more competitive rate.

[1] http://www.independent.co.uk/news/business/news/ireland-s-economy-grows-263-in-2015-as-corporations-flock-to-low-tax-rate-a7133321.html

[2] http://www.livemint.com/Money/ybhCrBCOyXfRapVgNHPNVL/The-budget-should-cut-corporate-tax-rates-drastically.html

[3] An alternative tax base premised on taxing net distributions from a country's corporate sector was explored in Heath, et al (2012). The author contributed to that review of the potential for strategic tax reform, a joint project between the UK TaxPayers' Alliance and Institute of Directors.

There are a number of problems created by high corporate tax rates, which could be addressed with our proposed reform. They:

- Discourage investment and depress wages – the reform proposed here could be expected to raise the average worker's wages by around $1,500 to $2,000 a year.
- Encourage international investors to look elsewhere – many other developed economies (including Japan, the Netherlands and the UK) have substantially cut their rates, while Australia has not kept pace.
- Create harmful distortions in firm behaviour – the reform proposed here could reduce the broad debt-asset ratio of Australian firms by 2.8 percentage points by addressing the debt-equity bias and mitigate other distortions.

Even substantial cuts in corporate tax rates, of the sort proposed here, would have only a manageable impact on the public finances. Greater investment and higher wages would expand the tax base, increasing the amount raised by the Government for a given rate, and erode the initial reduction in revenue over time.

High corporate tax rates discourage investment and depress wages

Corporate taxes are often described as taxes on the firm, but they are ultimately borne by individuals: the firm's shareholders, customers or workers. Companies do not pay company taxes any more than goods and services pay Goods and Services taxes.

If the capital stock were fixed, if people did not choose whether to invest in a given jurisdiction based on the likely returns on their investment, the burden of corporate taxes would fall on shareholders. The tax would take a share of the profits used to provide a return to capital.

The capital stock is not fixed, though, and investors will only invest in a project that delivers a certain return (adjusted for their risk- and time-preferences), matching alternative uses for the money (including spending it immediately). Taxes on profits mean that fewer potential investments generate a sufficient return. The lost investments represent a deadweight loss resulting from corporate taxes, economic activity which does not take place thanks to the tax system.

Less investment means a diminished capital stock. That might mean out of date equipment in factories, fewer new factories being built, fewer offices being opened or fewer mining projects opening. In turn, that reduces the productivity and potential earnings of labour. Workers cannot earn as much as they are able to add less value with less capital complementing their labour. As a result, it is broadly accepted in the theoretical literature that, for "a wide range of plausible parameter values, a substantial fraction of the burden of a general profits tax is borne by labour" (Feldstein, 1974). In other words, the tax takes a share of wages that would otherwise be paid to workers.

This theoretical result has been borne out in numerous empirical studies:

- Research for the American Enterprise Institute found that "a one per cent increase in Corporation Tax rates is associated with a nearly one per cent drop in wage rates" (Hassett & Mathur, Taxes and Wages, 2006). Another study by the think tank found that the "elasticity of wages with respect to the effective marginal or average corporate tax rate varies from 0.4 to 0.6, suggesting that a $1 increase in the tax revenue leads to a nearly $3 to $4 decrease in the real wage" (Hassett & Mathur, 2010).
- Felix (2009) found that a "one-percentage-point increase in the marginal state corporate tax rate reduces wages 0.14 to 0.36 percent."
- Desai, Foley and Hines (2007) found that the "baseline estimate for the share of the burden borne by labor is 57 per cent, and estimates vary between 45 and 75 per cent, depending on the sample period and specification." Their paper effectively excludes the possibility of a deadweight loss, however (Arulampalam, Devereux, & Maffini, 2012).
- Arulampalam, Devereux and Maffini (2012) report that "the long run elasticity of the wage bill with respect to taxation is 0.093", which "implies that an exogenous rise of $1 in tax

would reduce the wage bill by 49 cents", but note that those results do not capture the full effect of the tax cut.

The authors of the last and most recent paper in that list note that its empirical results only refer to the "direct effect" (labour and capital bargaining over fixed quasi-rents) not the "indirect effect" of corporate taxes on investment and thereby labour productivity (which may be more important) as they control for pre-tax value added per employee. The authors note that many of the papers described above may have a similar problem. However it is also possible that, while those studies account for the impact on wages, they do not account sufficiently for the impact on prices (higher corporate taxes might reduce prices as well as wages).

In a summary of the empirical literature, Gentry reports a "consistent empirical picture of corporate tax incidence" that "labor bears a large burden from the tax, possibly exceeding the revenues collected from the tax". That study also discusses theoretical papers which account for the potential effect of corporate taxes on the overall price level and find that the labour bears around three quarters to all of the burden of corporate tax rises. (Gentry, 2007).

Given the challenges in executing an empirical study of this issue, but the strong degree of consistency in the empirical and theoretical findings, it seems reasonable to believe that between 75 per cent and 100 per cent of the burden of a rise in corporate taxes is borne by labour, particularly in an open economy like that in Australia (the effect implied by some studies is considerably more than 100 per cent, which is possible given the deadweight loss).

Company tax was estimated to have raised $68bn in 2014-15 at the 2015 Budget. If the tax were cut by a third, from 30 per cent to 20 per cent, that implies a reduction in the corporate tax burden of around $23bn. **Across the Australian labour force of around 11.5m workers, the proposed reform would therefore result in an average increase in wages of around $1,500 to $2,000 a year for each worker.** The rest of that $2,000 (plus the deadweight loss) will be saved by Australian savers and other investors.

HM Treasury (2013) analysis of UK corporate tax cuts (from 28 per cent in 2010 to 20 per cent in 2015-16) using a CGE model found that they produced benefits on that kind of scale, producing in the long-run:

- An increase in investment of 2.5 to 4.5 per cent.
- An increase in GDP of 0.6 to 0.8 per cent.
- An increase in wages of the equivalent of around $900 to $1,100.

For reasons discussed later, in the consideration of the revenue impacts of our proposals, those estimates should be seen as conservative. With a somewhat larger corporate tax cut in Australia, from a higher base relative to international peers, greater economic gains can be expected.

High corporate tax rates relative to Australia's peers encourage international investors to look elsewhere

High corporate tax rates would depress investment even in a closed economy. In a relatively open economy like that in Australia, however, the effects of high corporate tax rates are particularly pronounced. International investors and multinational firms will prefer investments in jurisdictions where they will be allowed to keep more of the returns. Capital is more mobile than labour (to put it simply: it is easier to move your money than your family) and therefore corporate taxes are borne by labour, while investors find better prospects elsewhere.

The effect on international investment will be particularly profound in those sectors like business services and manufacturing where it is possible for business to locate in many jurisdictions. Those where there are natural limits on where economic activity can take place (e.g. mining) will be affected less. High corporate tax rates may therefore create an artificial concentration of economic activity in a narrow range of sectors, those where a country has some difficult-to-replicate advantage, although all sectors are likely to suffer to some extent.

Ireland was one of the first developed economies to adopt a low corporate tax rate in order to attract investment and improve economic outcomes. The country subsequently enjoyed a long boom and is now one of the most prosperous economies in the EU, the eurozone crisis notwithstanding. Since then other, larger economies have followed that example and cut the headline rate of corporate tax.

Australia used to have a competitive corporate tax rate, but has fallen behind its developed economy peers. The UK, for example, had the same corporate tax rate as Australia up to 2007, but has since implemented a ten percentage point cumulative cut (plans have already been announced to reduce that rate to 18 per cent by 2020). **In the last ten years, Canada, the Czech Republic, Greece, Israel, Japan, the Netherlands, Spain and the UK have all cut their corporate tax rate by five per cent or more while Australia has held its rate constant.**

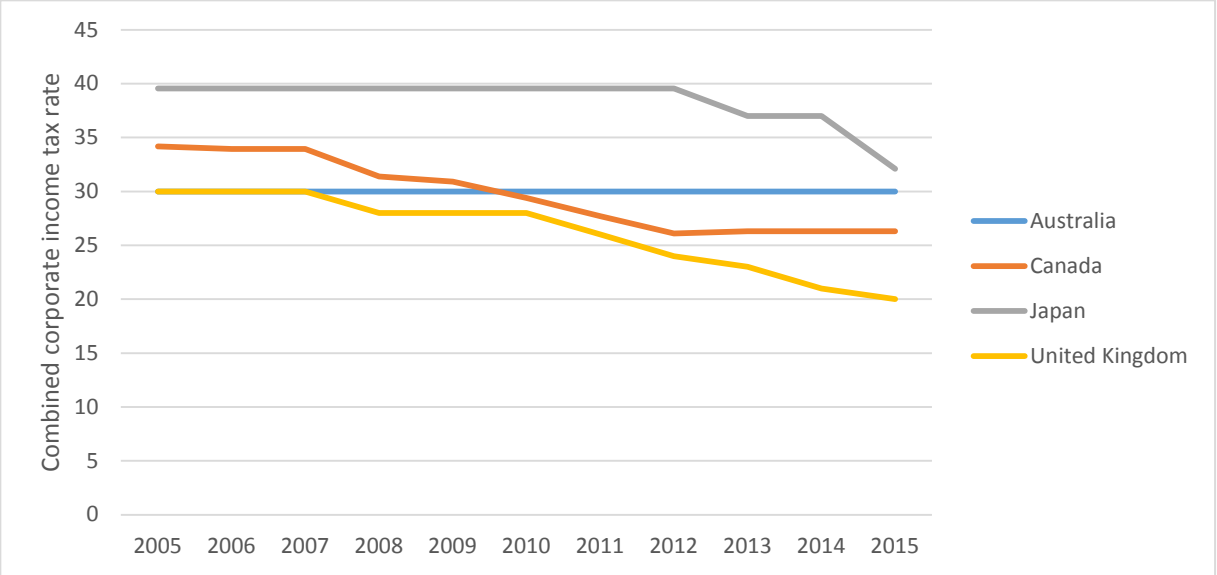

Figure 1: Reductions in corporation tax rates elsewhere, Australia holds rates constant (Source: OECD.Stat)

Corporate tax rates are lower than in Australia in most Asian economies, including Indonesia (25 per cent), Malaysia (25 per cent), Korea (24.2 per cent) and Singapore (17 per cent).[4]

It is important to note that this difference is not simply an artefact of the corporate tax structure. It is not that, for example, more generous reliefs or a lower burden for other taxes reduces the taxes incurred by Australian businesses and compensates for a high headline rate more than in other countries. First, it is widely thought that a high headline rate might have particularly pernicious economic effects (as it the rate most apparent to investors) and therefore the headline rate is significant in itself. Second, when we look at measures designed to provide a more complete picture, like the Total Tax Rate borne by business,[5] Australia still has a high rate relative to its peers. The headline and total tax rates for business in the economies discussed are shown in Table 1.

Table 1: Headline and total corporate tax rates

Country	Combined corporate income tax rate, %	Total tax rate, %
Australia	30	47
Canada	26	24
Indonesia	25	32
Japan	32	50
Korea	24	28
Malaysia	25	36
Singapore	17	27
United Kingdom	20	34

[4] There is a full account of the prevailing rates in different economies in August 2015 available here: http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-corporate-tax-rates-2015.pdf

[5] Defined as: "the amount of taxes and mandatory contributions borne by the standard company (as a percentage of the 'commercial profit' or the profit before all of those taxes)" (PwC, 2014).

While there are exceptions to the general trend for falling corporate income tax rates, those exceptions do not represent a good model for Australia:

- Sclerotic EU Member states. France, for example, has not cuts its corporate income tax rates, but its economy has been slower-growing and less attractive to international investment than would or should be politically tolerable in Australia.
- The US. Large economies generally tend to maintain higher corporate income tax rates (Azemar, Desbordes, & Wooton, 2015), as firms are more likely to put up with a high corporate tax rate to access a large market, and the US is a very large economy. The US also maintains an extensive system of exceptions and reliefs which is particularly generous (though often distorting of economic activity). Despite all that, the high rate is still creating problems, with a growing trend (which also reflects US rules on taxation of foreign earnings) to "inversions", where firms relocate to other jurisdictions for tax reasons (Economist, 2015). There have been a number of proposals to cut the US headline rate, for example a proposal from President Obama to cut the rate to 28 per cent (in exchange for the removal of certain reliefs), which critics said still left rates too high (Pozen, 2015).

Australia should not tolerate the economic price paid in the US and some EU Member States for a high corporate tax headline rate. It has only fallen behind its peers recently and can and should catch up.

High corporate tax rates create harmful distortions in firm behaviour

Corporate taxes tend to create a number of distortions in the tax system.

There are often kinks in the marginal rate structure, associated with special rates for smaller businesses, capital allowances and the interaction with Income Tax. There is evidence in the UK of "firms choosing to locate their taxable profit at kink points in the marginal tax rate schedule" (Devereux & Loretz, 2011). Similar distortion may well exist in Australia with the lower rates for small business entities and other allowances.

There are often differences in how international income is treated, leading to incentives to locate certain investments in certain jurisdictions. The "magnitude of US multinational cash holdings are, in part, a consequences of the tax costs associated with repatriating foreign income" (Foley, Hartzell, Titman, & Twite, 2007). While this issue may to some extent be a unique feature of the US corporate tax structure, profit shifting and other distortion associated with international income is a feature of all conventional corporate taxes.

The disparities that most concern policymakers, however, are in the treatment of debt- and equity-financing, since firms can deduct interest paid on debt but not the dividends paid on equity. This is widely seen as a serious problem with conventional corporate tax structures (de Mooij, 2011):

> *One cannot compellingly argue for giving tax preferences to debt based on legal, administrative, or economic considerations. The evidence shows, rather, that debt bias creates significant inequities, complexities, and economic distortions. For instance, it has led to inefficiently high debt-to-equity ratios in corporations. It discriminates against innovative growth firms, impeding stronger economic growth. Debt bias also threatens public revenues, because it enables companies to reduce tax liabilities by using hybrid financial instruments as well as by restructuring their finances internally, moving debt between affiliates.*

That research cited an IMF Working Paper which quantified the effects of the disparities and found that a "consensus estimate" of the impact of the coefficient for the corporate income tax rate on debt-asset ratios, "lies somewhere between 0.17 for narrow and 0.28 for broad measures of financial leverage." **That would imply that a reform of the sort envisaged here, reducing the rate by 10 percentage points, would reduce the debt-asset ratio by 2.8 percentage points (e.g. from 50 to 47.2 per cent).** There is evidence that this effect is becoming stronger over time and that it is stronger with intra-company debt at multinationals than with third party debt.

With a lower rate, all these distortions would be considerably less pronounced (as there would be less benefit in changing corporate decisions to reduce corporate tax liabilities). This has two kinds of benefit: first, firms are likely to take better decisions (more conducive to their growth, for example, or less risky); second, scarce executive attention can be devoted to other business activities, leading to a general improvement in decision-making.

The effect on revenue would be manageable

The immediate effect of a cut in corporate tax rates will be a reduction in tax revenue: less money is taken for each dollar of taxable corporate income. Over time, however, more investment and the resulting productivity gains increase the amount of economic activity (there are more dollars of taxable income). That means, for a given rate, higher corporate tax revenues and also higher revenues from other taxes such as Income Tax and Goods and Services Tax.

This effect has been quantified in multiple studies:

- Brill and Hassett (2007) found that the revenue-maximising rate has fallen from 34 per cent in the late 1980s to 26 per cent in 2003. Given that the revenue-maximising rate will depend, in large part, on rates in competing economies and many peer countries have substantially cut their rates, that revenue-maximising rate is likely to have fallen further in the 12 years since. They also found the revenue penalty for being above the revenue-maximising rate was rising, as capital becomes more mobile.
- The same phenomenon exists at a subnational level. Stinespring (2009) studied US states and found that the revenue-maximising rate had fallen from around 9 per cent over the period 1996 to 2002 to around 7 per cent over the period 2003 to 2007. Those results implied 22 states had set their rates above the revenue-maximising level.
- While other studies have found that a reduction in corporate tax rates tends to reduce revenue, they still find that a rise in corporate taxes leads to a significant reduction in the size of the tax base, blunting the impact on revenues (Riedl & Rocha-Akis, 2009).

HM Treasury analysis of UK corporate tax cuts using a CGE model found that "increased profits, wages and consumption all add to higher tax revenues", reducing the cost of the policy by between 45 per cent and 60 per cent in the long term (HM Treasury, 2013).

There are two limitations in that analysis which mean it should be seen as conservative:

- First, it does not capture the effect of Corporation Tax in encouraging investments that embody new innovations in the capital stock, or resulting technological spillovers (meaning it does not capture the potential impact on long-run GDP growth, just the equilibrium level of GDP).
- Second, it relies on an ad hoc adjustment to reflect the role of corporate taxes in affecting international investment decisions (as it does not model the international economy).

Still, the results suggest that the measure produced very large economic gains and reduced government revenues much less than would be suggested by a static analysis.

In modelling for the UK TaxPayers' Alliance, the Centre for Economics and Business Research (CEBR, 2007) found that a programme of two per cent a year cuts in the corporate tax rate to the Irish level (12.5 per cent) would lead to substantial gains in GDP, investment and employment. While the measure would reduce revenues initially, within a decade it would increase revenues.

More recently, research by PriceWaterhouseCoopers has found that lowering the corporate tax rate to 25 per cent from 30 per cent would increase revenue within five years and increase GDP by $100bn (Greber, 2015). That GDP gain equates to an over $4,300 increase in per capita GDP, though population may also rise somewhat.

The evidence therefore suggests that, while corporate tax cuts may reduce revenue initially, that impact on revenue will be significantly less than a simple static analysis suggests and will diminish over time. Lower corporate tax rates lead to increased productivity and higher incomes and the Government will take

its cut with corporate and other taxes. Phasing in cuts to corporate tax rates makes the initial impact on revenue easier to bear.

Author bio

Matthew Sinclair is an economist based in London, working as a Senior Consultant at Europe Economics. He has produced studies there on a range of topics including the impacts of major financial regulations, the likely evolution and policy implications of the Sharing Economy and the consequences of policy costs in consumer industries. Before joining Europe Economics, he worked at the UK TaxPayers' Alliance (TPA) where he was responsible for award-winning campaigns including the 2020 Tax Commission, a major joint project with the Institute of Directors reviewing the potential for strategic tax reforms. He has published two books: *How to Cut Public Spending*, on practical fiscal policy, and *Let Them Eat Carbon*, on the consumer impacts of climate policy.

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