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Submission to Senate Inquiry into the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016

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Submission – Inquiry into the Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016

Summary

The Senate Inquiry into the *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016* is to be welcomed. This submission evaluates the case for the Government's plan to cut the company tax rate from 30 to 25 per cent over 10 years.

It is an article of faith in Australia's business community that corporate tax cuts are the big lever for increasing economic growth.¹ Australia's corporate tax rate is high relative to most developed countries. OECD studies show that lower corporate tax rates tend to lead to higher investment and hence higher economic output.² Many studies – including the 2012 *Game Changers* report for Grattan Institute³ – picked up this research and highlighted company tax cuts as one of the big opportunities for government to increase prosperity.

Yet ironically legislation to cut the company tax rate over 10 years⁴ has been introduced at the precise time that doubts are growing about the payback of corporate tax cuts, especially for countries such as Australia that have dividend imputation systems.

Australia's unusual dividend imputation system means that domestic investors are largely unaffected by the company tax rate since any profits paid to them are taxed at their personal income tax rate. Yet because foreign investors, by contrast, do not benefit from dividend imputation, a cut to the company tax rate provides

bigger benefits to them. For those who have already made long-term investments in Australia, a reduction in the tax rate would be a windfall. Many of the international studies about the economic impacts of cutting corporate tax rates are therefore not readily applicable to Australia.

The Government maintains that the change will boost GDP by more than 1 per cent in the long-term, at a budgetary cost of \$48.2 billion over the next 10 years. But the best analysis from the Commonwealth Treasury shows that the net benefits to Australians' incomes will be much smaller once profits flowing out of Australia are taken into account. Raising other taxes to compensate for the foregone company tax revenue will create their own economic costs. Because additional corporate investment will phase in slowly, the benefits of company tax cuts for Australian incomes will be a long time coming. And the substantial costs of the measure in the short term could see company tax cuts drag on national incomes for the next ten years. Weighing the balance, it is not clear that corporate tax cuts should be Australia's top priority.

Instead, wholesale company tax cuts should be deferred until we have eliminated the large and persistent budget deficits that increase the vulnerability of the Australian economy, and drag on future incomes. In the interim, corporate tax reform should focus on providing tax cuts in ways that minimise the windfall for existing foreign investors. Options include an investment allowance or faster depreciation rates that only apply to new investments.

¹ BCA (2016)

² Johansson, *et al.* (2008)

³ Daley, *et al.* (2012), p.31

⁴ Treasury (2016a), p.41

1 The theory and practice of corporate tax reform

1.1 The traditional theory

In theory, cutting the company tax rate boosts the economy in the long term. All taxes distort choices, and thereby drag on economic activity. Taxes on capital often have especially large economic costs because they discourage investment, which is mobile across borders. By some estimates, roughly half of the economic costs of Australian company tax ultimately fall on workers, as lower company profitability leads to lower investment, and therefore lower wages and higher unemployment.⁵

But while the theoretical argument for company tax cuts is straightforward, the real story is more complicated.

1.2 Incorporating dividend imputation into the theory

Australia's unusual dividend imputation system means that when profits are paid out, they are only taxed at the domestic investors' personal income tax rates. A company tax cut does not help them much since their effective company tax rate is already close to zero.

This system is known as a franking credits regime and other few developed countries have it.⁶ Most countries tax corporate profits, and then investors also pay personal income tax on the dividends (albeit sometimes at a lower rate).⁷ As a result, although Australia

has a relatively high headline corporate tax rate compared to our peers, in practice the comparable tax rate is lower – at least for local investors.

By contrast, corporate taxes have a much bigger economic impact in other OECD countries where they reduce the rate of return for local investors. International comparisons show that Australia has a median level of taxes on corporate profits for local investors when both company taxes and individual income taxes are considered (Figure 1).

Consequently, many of the international studies about the economic impacts of cutting corporate tax rates do not readily apply to Australia.

Local shareholders do get one benefit from cutting corporate tax rates. If companies pay less tax, then they have more to reinvest, so long as the profits are not paid out to shareholders.⁸ Yet in practice, most profits are paid out.⁹ Therefore a company tax cut will generate little change in domestic investment.

⁵ Freebairn (2015)

⁶ Along with Canada, Chile, Mexico and New Zealand, Australia is one of only five countries in the OECD that continues to operate a full imputation tax system where all corporate tax is credited to domestic shareholders. Ainsworth (2016).

⁷ Dixon and Nassios (2016)

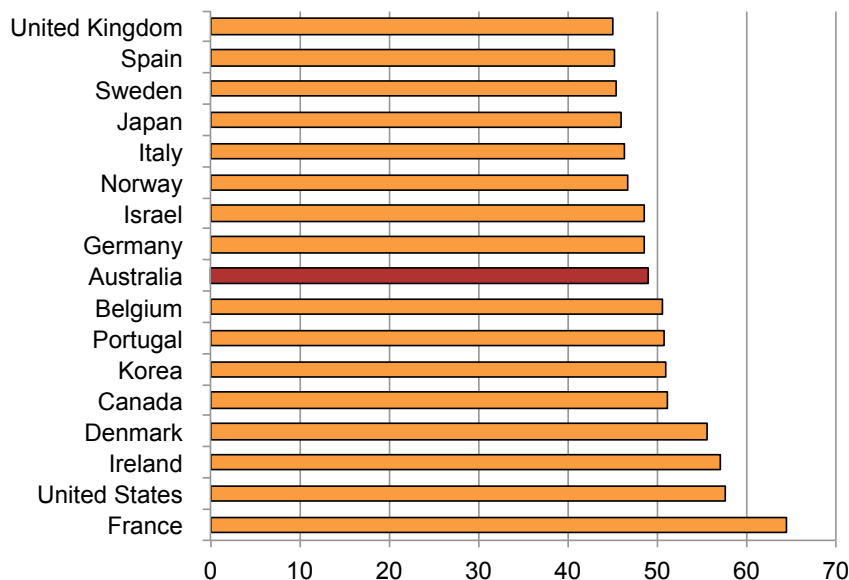
⁸ In time, government will recoup a portion of the additional income on the larger investment via capital gains tax of the higher share price and income tax on higher future dividends. Freebairn (2016).

⁹ Murphy (2016)

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Figure 1: Effective tax rates on Australian corporate investors are not particularly high

Overall (corporate + personal) tax rate on company income (top marginal income tax rate)



Notes: Calculated at top personal tax rate, and allowing for imputation and other concessions.

Source: OECD, as per Davis (2015).

Foreign investors, on the other hand, do not benefit from franking credits. They pay tax on corporate profits twice: first at the company tax rate, then as income tax on the dividends at home (potentially at a discounted rate). Therefore a cut to the company tax rate provides bigger benefits to them. For those who have already made long-term investments in Australia, a reduction in the tax rate would be a windfall.

The Australia Institute has pointed out that foreign investors from the United States and other countries that have tax treaties with Australia may not even benefit from the company tax cut, because their home governments will collect the gains from any cut to Australian company tax as additional company tax.¹⁰ But this effect can be overstated. Foreign firms will only pay the extra tax when they repatriate profits earned in Australia to their home country. Many US firms have been very slow to repatriate profits for this precise reason.

¹⁰ Richardson (2016a)

2 Impacts on national income

2.1 Economic activity is not the same as national income

A recent Treasury research paper revised the estimates of the impact of a corporate tax cut.¹¹ One headline was that in the long run – over 20 years – the cut in the company tax rate from 30 per cent to 25 per cent would increase GDP by 1.2 per cent as larger foreign companies are attracted to invest more in Australia.¹²

Yet it is a mistake to assume that all the increase in economic activity will make Australians better off. We often use Gross Domestic Product – the sum of all economic activity – as a shorthand measure for prosperity. But when the benefits disproportionately flow to non-residents, GDP can be misleading. It's much better to look at Gross National Income (GNI), which measures the increase in the resources available to resident Australians.

A corporate tax cut increases economic activity (measured by GDP) by more than it increases national incomes (measured by GNI). When foreign-owned corporates pay less tax, more money flows out of the Australian economy. And most of the profits on their additional investments in Australia don't benefit Australians.

Treasury estimated that cutting corporate tax rates to 25 per cent would only increase the incomes of Australians – GNI – by 0.8 per cent. Roughly a third of the benefits of greater economic growth would go to foreigners.

¹¹ Kouparitsas, *et al.* (2016)

¹² Treasury (2016b)

2.2 Funding the corporate tax cut

The story doesn't end there. Tax cuts must be funded from elsewhere. If company taxes are lower, other taxes have to be higher, all other things being equal.¹³ And those other taxes will typically impose economic costs of their own.

In the modelling discussed so far, Treasury first assumes that the company tax cut is funded by a fantasy tax that imposes no costs on the economy.

But that's not what happens in the real world. So the Treasury research paper also models a scenario in which the company tax cut is funded by a hypothetical flat rate personal income tax. On this more realistic assumption, Treasury estimates that GNI will increase by just 0.6 per cent in the long term, or roughly \$10 billion a year in today's dollars (Figure 2). Alternative economic modelling produced by Chris Murphy of Independent Economics reaches the same conclusion.¹⁴ The reform might still be worth doing, but it's less of a game-changer.

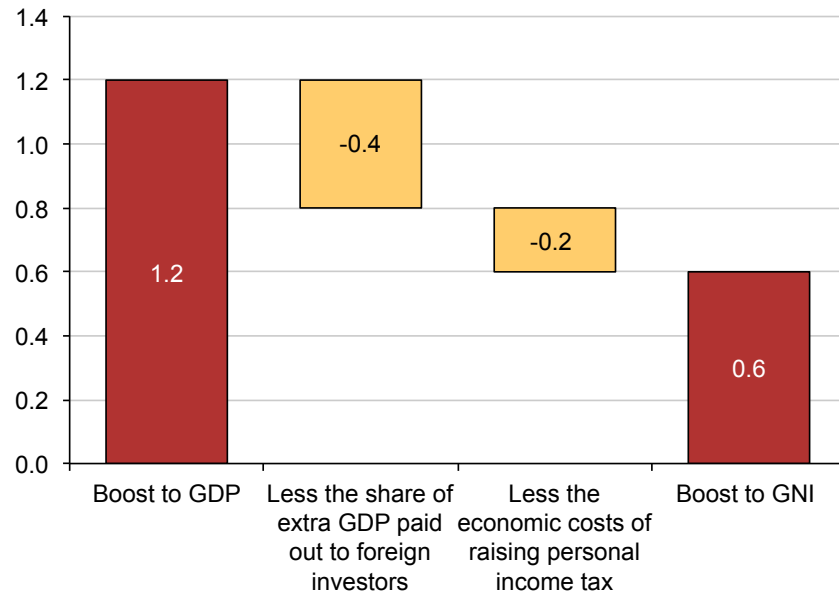
¹³ While some of the budgetary costs of the company tax cut will be recovered via higher tax receipts arising from a larger economy in the long-term, a company tax cut is unlikely to be self-funding. Freebairn (2016).

¹⁴ Murphy (2016)

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Figure 2: The company tax cuts are likely to boost incomes by no more than 0.6 per cent

Expected long-term boost to GDP and GNI from a cut in the company tax rate from 30 per cent to 25 per cent, Per cent of GDP and GNI



Note: The above chart uses results from the Treasury analysis of the 2016-17 Budget changes. It compares the increase to GDP under the scenario where the company tax cut is funded by a hypothetical, non-distorting tax and the increase to GNI where the cut is funded by an increase to a flat personal income tax. Source: Treasury (2016b); Table 3; Grattan analysis.

Even this more modest Treasury figure may well over-estimate the long-term boost to GNI. In the real world, progressive income taxes impose higher costs than the hike to a hypothetical flat-rate personal income tax that Treasury modelled.¹⁵ Companies may not increase investment as much as Treasury expects¹⁶, and those firms that are part of oligopolies in Australia may not increase wages by as much as Treasury assumes.

While these are reasons to expect that the Treasury modelling overestimates the economic benefits of a company tax cut, they are offset by some more conservative assumptions.

For example, Treasury’s assumption that tax cuts only modestly change how much firms shift profits overseas may understate how much firms decide to retain profits in Australia as a result of the company tax cut. Second, in those industries that it recognises as oligopolies, Treasury may overstate how much of the benefit of a company tax cut may flow into additional profits rather than higher wages due to the way it models oligopolies.¹⁷ Third, Treasury may discount the benefits of investors making less distorted choices between debt and equity funding.

¹⁵ KPMG Econtech (2010)

¹⁶ For example, Dixon and Nassios (2016) find, using alternative modeling assumptions, that cutting the company tax rate could reduce gross national income in the long term.

¹⁷ For instance, Kouparitsas, *et al.* (2016) assume that oligopoly rents are generated by some unidentified fixed factor that absorbs some of the economic costs of company tax, whereas Murphy (2016) makes the more realistic assumption that these rents are generated by oligopoly power (p.21).

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2.3 Overall economic benefit in context

The overall economic benefit of a 0.6 per cent increase in GNI needs to be seen in context. If Australian per capita GDP and GNI increase at 1.5 per cent a year (as the budget papers routinely assume), then over 25 years, incomes will rise by 45.1 per cent. Corporate tax cuts mean that instead, incomes will rise by closer to 46 per cent. It may still be worth doing, but it's not a plot twist that dramatically changes Australia's story.

Others claim that in the past, company tax cuts have had *no* measurable effect on the economy.¹⁸ This is disputed – there may well be a link between corporate tax cuts and economic growth.¹⁹ But it's inevitably hard to see in practice because on Treasury's own modelling the economic effect of company tax cuts is small relative to the overall growth in the economy.

Company tax cuts would be imperative if, without them, there would be no foreign investment in future. But tax cuts only affect decisions at the margins. Despite a company tax rate of 30 per cent, more money was invested in mining projects in Australia than in any other country in the world for each of the eight years of the mining boom.²⁰ Corporate investment decisions don't just turn on tax rates – they also consider Australia's stable government, educated workforce and developed economy.

¹⁸ Richardson (2016b)

¹⁹ Potter (2016)

²⁰ Minifie, *et al.* (2013)

2.4 Comparing tax costs and economic benefits

It has been argued that 'for every dollar of company tax cut, there [would be] four dollars of additional value created in the overall economy'.²¹ An analysis of this claim subject to the same caveats as those that apply to the analysis of overall economic growth finds that:

- The claim is about GDP, whereas the impact on Australian incomes (or GNI) is smaller - only \$2.80 per dollar of company tax cut.
- When corporate tax is replaced by a flat rate income tax rather than an imaginary tax with no impact on the economy, the increase on Australian incomes is only \$1.80 per dollar of company tax cut.
- The "dollar of company tax cut" is not the dollar of tax revenue given up in the shorter term, as many would assume.²² Instead it is calculated net of the increase in tax revenues that the government hopes to collect from all taxes in twenty years time as incomes rise because of greater investment. For every dollar given up in the short term, the increase to Australian incomes in the long term is only \$1.20.²³

²¹ Crowe and Uren (2016). The claim appears to be based on Cao, *et al.* (2015), although the more recent paper, Kouparitsas, *et al.* (2016), implies a slightly larger \$4.30 increase to GDP from each \$1 in revenue cut.

²² E.g. Crowe and Uren (2016)

²³ For a more detailed discussion, see Daley and Coates (2016a)

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2.5 Dynamic analysis: the journey matters

So far, like the authors of the Treasury research paper, this submission has focused on the long-term economic boost from a company tax cut once the economy has fully adjusted. But the journey to get there and the losses along the way also matter.

Inherently, a tax cut for foreign-owned companies – as the legislation effectively proposes – would reduce Australian incomes for about a decade. It would reduce government revenue – and national income – as soon as large foreign companies start to pay less tax on their existing investments. Foreigners own about 20 per cent of capital stock in the economy, so it's a big windfall gain for them.²⁴ We estimate that when a 5 percentage point tax cut for big business is first implemented, national incomes will be reduced by about 0.5 per cent, as a result of the immediate loss in company tax revenues formerly paid by foreign investors.

The benefits to Australians from a corporate tax cut only accumulate slowly as foreigners make additional investments in Australia. Treasury cites a paper that estimates that the benefits of corporate tax cuts take 20 years to flow through.²⁵ Assuming these benefits increase at a constant rate, Australian income would not be larger than otherwise until about 10 years after the change is introduced. The ultimate improvement to GNI would be 0.6 per cent – as calculated by Treasury and others – but it would take 20 years to get there.

Of course, the up-front costs of a company tax cut over the first decade must be offset against the long-term gains. On our estimates, the cumulative loss of income incurred over the first decade will only be offset by higher incomes after about 19 years. In other words, the benefits of a corporate tax cut are modest, and will not arrive quickly.

²⁴ Kouparitsas, *et al.* (2016) (p.34) estimate that 20.7 per cent of domestic firms were owned by foreigners, based on ABS National Financial Accounts.

²⁵ *Ibid.*, p.6

3 Budgetary trade-offs

3.1 Budgetary impacts

The economic benefits of large cuts to the company tax rate also have to be weighed against their budgetary cost. Treasury expects the Government's company tax plan to cost the budget \$48.2 billion over the next 10 years.²⁶

The Commonwealth's stubborn budget deficit has persisted at around 2 to 3 per cent of GDP for eight years.²⁷ Many think that the latest budget estimates are again too rosy, and there will be little improvement for several more years.²⁸ Is it the right time to hurt the bottom line with cuts to corporate tax that won't pay back for over a decade? It is arguably more important to balance the budget earlier, so that we can reduce the chances of a credit rating downgrade, and be able to shore up growth in the event of another downturn.

3.2 Alternatives to a corporate tax cut

There are alternatives to a full-blown company tax cut that could boost investment without delivering large windfall gains to foreign investors at such cost to the budget bottom line. Grattan Institute's *Orange Book 2016* suggests lowering effective company tax rates via investment allowances or accelerated depreciation on new investment.²⁹

An investment allowance, via a tax deduction to businesses for the purchase of new assets, would provide incentives to boost investment. Since the deduction would apply only to future investments, not past ones, it provides incentives to investment without sacrificing tax revenue on existing investment.

In the past, including at the height of the Global Financial Crisis, governments have adopted investment allowances to promote investment.³⁰ In its 2015-16 Budget the Coalition included an accelerated depreciation allowance, albeit only for small businesses.³¹ Some argue that the unwillingness of major business groups to engage with these alternatives suggests they are less interested in the economic gains than in the windfall benefits of a tax cut.³²

²⁶ Fraser (2016)

²⁷ Daley and Wood (2015)

²⁸ Daley and Coates (2016b)

²⁹ Daley, *et al.* (2016), p.3

³⁰ For example, see Swan (2008).

³¹ Treasury (2015)

³² Emerson (2016)

4 Conclusion

It is true that corporate tax cuts will increase investment, jobs and economic output. But the best analysis from the Commonwealth Treasury shows that the benefits to Australians will be smaller once you take into account how the profits flow out of Australia, and the costs of other taxes to compensate. Because additional corporate investment will phase in slowly, the benefits of company tax cuts for Australian incomes will be a long time coming. And there are substantial costs in the ‘short term’ – the next ten years. Weighing the balance, it is not clear that corporate tax cuts should be the Government’s top priority.

Instead, wholesale corporate tax cuts should be deferred until we have eliminated the large and persistent budget deficits that increase the vulnerability of the Australian economy, and drag on future incomes. In the meantime, corporate tax reform should focus on providing tax cuts in ways that minimise the windfall for existing foreign investors. Options include an investment allowance or faster depreciation rates that only apply to new investments.

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