OUR TREASURER SHOULD CULTIVATE AN IRISH LILT

Australia could learn from Ireland's corporate tax system, writes
Geoffrey Kingston

Ireland is reaping the rewards of fearlessly leading the pack. As recently as 1995 she languished in seventeenth place on the league table of gross domestic product per head in the Organisation for Economic Cooperation and Development (OECD). By 2002 she had risen to fourth position. The obvious explanation of Ireland's recent success is her bold cuts in business taxes designed to lift business investment, especially by foreign businesses. Since 2004 Ireland's tax rate for domestic and foreign corporations alike has been 12.5%.

By contrast, the Australian Treasury has had to be dragged kicking and screaming into following the OECD trend towards lower business taxes. This year, for example, our corporate rate is 30%, compared to an OECD average of 28.5%.

Between 1996 and 2005 net foreign direct investment (FDI) into Australia was US$45 billion, compared to US$43 billion in the case of Ireland, which has a population only one fifth of ours.[1] Our Treasurer has a fine Irish name but he needs to bring an actual Irish lilt to the budget deliberations.

Low business taxes or other factors?

There is of course a debate about the weight that should be placed on corporate tax breaks relative to other factors behind Ireland's success. There are

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three leading alternative explanations: subsidies to Ireland via the Common Agricultural Policy (CAP) of the European Union, geographic proximity to markets, and Irish skills derived from command of English together with a science-intensive education.[2]

That the CAP gave Ireland her leg-up is an explanation endorsed within the Australian Treasury. This year's Warburton-Hendy tax report, prepared under Treasury's auspices, begins its discussion of the sources of Irish prosperity by drawing attention to the fact of 'generous assistance from the European Union'.[3] Not mentioned is the fact that Portugal and Greece enjoyed comparable levels of support yet have continued to languish in the bottom half of the OECD league table.[4]

Treasury does acknowledge that Ireland has had low direct taxes, but glosses over the important distinction between low personal rates and low corporate rates, as when it says: 'Ireland's low tax rates were just one ingredient in the policy mix'.[5] Treasury wraps up its discussion of Ireland with a condescending half-truth: 'Recent measures' in that country 'have been aimed at reducing tax distortions', resulting in a tax system that is 'less distortionary.'[6] Yet Treasury kicks off with the following disclaimer: 'The objective of this report is to provide an authoritative statement on how Australia's taxes compare with those in other countries, without making policy recommendations or judgments.'[7] Evidently the Irish case hits a raw nerve within our official family.

Geographic proximity to markets is an explanation endorsed within the New Zealand Treasury. Sarah Box of that organisation carried out a comprehensive study of why Ireland has recently enjoyed more economic success than New Zealand.[8] Box places more weight on the distance factor than any other when explaining Ireland's superior performance, using concentric circles to demonstrate the relative closeness of Ireland to major markets.[9] Not mentioned is the fact that during the 1890s New Zealand was the richest country in the world.[10] Likewise, from the 1950s to the 1980s Japan rose faster up the league table than most, even though during that time she was a long way from her main markets.

Box does canvass tax factors. Like Hendy and Warburton, however, she emphasises (you guessed it) the 'distortionary' character of taxes in Ireland, not to mention the resulting 'significant distortions in resource allocation'.[11]

On educational performance, the OECD this year suggested that education has been a lagging (rather than leading) sector in Ireland: 'Educational outcomes are now broadly in line with the OECD average but still far below the results achieved by the best performers in the OECD.'[12]

Tax structures compared

If the leading alternative explanations of Ireland's newfound prosperity don't stack up, then we need to reconsider the tax factor, 'distortionary' or not. The following table compares and contrasts the structure of taxation in Australia and Ireland.

The total percentage contribution of personal income tax to total Irish revenue is better measured by adding the contribution of revenues from Ireland's conventional pay-as-you-go system of financing social security to the headline contribution of personal income taxes. In Ireland (as well as Australia) the public age pension is

Taxes in Australia and Ireland—2002

Country	Total tax receipts % of GDP	Tax structure % of total receipts					Highest rates of income tax	
		Personal income tax		Social security contributions Employees plus employers	Taxes on goods and services		Personal income tax %	Corporate income tax %
Australia	32	39	17	0	30	14	49	30
Ireland	28	26	13	14	40	7	42	16

Source: OECD, OECD in Figures, 2006

flat-rate rather than earnings-related. In contrast to most countries with pay-as-you-go systems, therefore, Ireland offers no incentive to work harder in order to boost your retirement income from the government. In the Irish case, then, it makes even more sense than usual to consolidate social security taxes and personal income taxes. Adding the two percentages gives an effective contribution by Irish personal income taxes to total Irish tax receipts of 14 + 26 = 40% in 2002—nearly the same as its Australian counterpart of 39%.

There are really three major differences in the tax structures of the two countries, and in each case we should move closer to the Irish model.

First, Ireland relies much more on revenues from taxes on goods and services. Ireland's Value Added Tax is generically the same as our Goods and Services Tax (GST), but most goods and services are taxed at 21%, compared to our single 10% rate. As a consequence, indirect taxes raise 40% of Irish revenues, compared to 30% here. Indirect taxes tend to do less damage to saving, investment and work effort than taxes on incomes.

Transiting to a higher rate of indirect tax has a distributional impact similar to that of a capital levy. In other words, rises in taxes on goods and services fall disproportionately on the owners of financial assets. Take the case of our GST, introduced in the year 2000. Inflation spiked up to 6% per year without a corresponding spike in the returns to financial assets. Rationally anticipating this economic outcome and the ensuing potential for a political backlash on the part of the main owners of substantial financial assets (the affluent elderly), our government was crafty. It packaged the GST with a range of pre-announced perks for seniors, such as liberalised access to carded benefits. But this year Mr Costello arbitrarily conferred a windfall on the affluent over 60s, in the form of tax breaks and liberalised means tests, without any offsets elsewhere in the budget. Doubling our rate of GST from 10% to 20% would not only make room for cuts in corporate taxes and, maybe, further cuts in personal taxes as well, but would hand this arbitrary windfall back to the wider community.[13]

Second, since 1987 Australia has had dividend imputation whereas in 1999 Ireland reverted to a classical system for taxing corporate profits. Dividend imputation removes the double taxation of dividend incomes flowing to the domestic owners of domestically located companies. This is of itself a good thing. But it has to be weighed against the consideration that the classical system not only creates room for deep cuts in corporate taxes but recognises that in a world of mobile capital it makes no sense to discriminate against foreign investors.

'Distortionary' taxes can actually be more efficient than uniform ones. Optimal tax theory, due to Frank Plumpton Ramsey,[14] amounts to an extended variation on this theme. Ramsey found that efficient taxation actually requires discrimination—'distortion' if you will—in favour of those factors of production whose supply is relatively responsive to changes in after-tax rewards. (Ramsey also pointed out that taxing income from assets acts to discriminate against future consumption relative to present consumption, a distortion that really is inefficient, unless the authorities can fool the public into believing that its savings won't be taxed.) Ireland's reversion to a classical system has already been widely copied in Eastern Europe. We should follow suit.

Ireland has recently seen extraordinarily low rates of corporate tax. In 2002 her highest corporate rate was just 16%.

Last but not least, Ireland has recently seen extraordinarily low rates of corporate tax. In 2002 her highest corporate rate was just 16%. By 2004 Ireland had implemented a plan (announced in 1999) for a universal rate of 12.5%. That year marked the end of Ireland's traditional policy: piecemeal tax breaks for foreign investors in selected industries, alongside substantially higher taxes for domestic investors across the board.

In 2002 taxes on domestic and foreign owned companies raised 13% of total Irish tax receipts, compared to 17% here—see the third column of figures in the table. In other words, Irish receipts from corporate taxes came fairly close to ours, notwithstanding Ireland's ultra-low maximum rate of 16% (now a uniform 12.5%.)[15] Because Ireland abolished dividend imputation in 1999, this outcome was all the more remarkable. Dividend imputation encourages domestically owned

companies to pay domestic corporate tax so as to generate franking credits for domestic shareholders. Franking credits eat into the total take from direct taxes.

Opponents of cuts in business taxes often worry about the prospect of rises in inequality. However, the OECD this year was reassuring: 'The fruits of the [Irish] economic boom have been widely shared' and 'measures of income inequality such as the Gini coefficient have fallen and by 2000 were around the OECD average.'[16]

The Irish experience with low business taxes has run counter to the so-called flypaper theory of tax incidence where all the benefits of a tax cut stick to the nominal or legal recipients of the cut in question. A standing temptation is first to give lip service to the theoretical possibility that the flypaper theory may not hold, and then proceed to analyse each particular tax cut as if the theory really did hold. That this temptation should be resisted is demonstrated by Kevin Hassett and Aparna Mathur of the American Enterprise Institute. They find striking confirmation of the proposition that business tax cuts lead to higher wages in manufacturing industry, based on a dataset consisting of 72 countries over the period 1981 to 2002. A 10% fall in the top national corporate tax rate, for example from 30% to 27%, leads to an 8% rise in wage rates in manufacturing, controlling for economic openness, educational attainment and other variables.[17] Hassett and Mathur identify the likely mechanism: increased investment, which progressively enables each worker to do his or her job with better machinery and equipment. Output per worker rises and wages are bid up.

The virtuous circle doesn't end there: higher wages lead to higher revenues from personal income taxes. This feedback effect is a further reason why cuts in business taxes could well be surprisingly inexpensive to consolidated revenue. A relevant fact is that Ireland's ratio of gross public debt to gross domestic product now ranks 'among the lowest in the EU',[18] despite periodic loosening of the public purse strings from 1999 onwards.

Foreign tax credits

Foreign tax credit systems, also known as worldwide tax systems, require a company that has enjoyed low taxes offshore to make up the difference when it repatriates profits. A contribution to the house journal of the Australian Treasury by James Kelly and Richard Graziani argued that foreign tax credit systems are not only dominant but act to prevent business tax cuts from stimulating inflows of FDI.[19] This line of argument was well received by Australian economic commentators, and is reiterated and updated in the Warburton-Hendy report. But it is rebutted by Irish experiences and debates.

Warburton and Hendy report that in 2004 at least 65% of our FDI came from countries with a foreign tax credit system and with company tax rates at least as high as ours.[20] Notably, the United States had a 49% share of our inward FDI, an overall company tax rate of 39%, and a foreign tax credit system. On the Treasury argument, cutting our corporate tax rate would merely deliver a free lunch to the Internal Revenue Service (IRS) without stimulating FDI.

But Irish experiences and debates suggest otherwise. In the year 2000, for example, Ireland succeeded in attracting US$15,623 per head in FDI. This was roughly twice as much as the United Kingdom, the next most successful European country in terms of attracting FDI. Moreover, much of Ireland's FDI came from the US. Irish commentators have identified two reasons why US multinationals actually find it tax efficient to invest in low-tax environments such as Ireland.[21] First, foreign incomes and taxes paid are aggregated by the IRS for the purpose of assessing foreign tax credits. So operating in low-tax environments generates offsets for US firms operating in high-tax environments, without their needing to pay more than the top domestic rate overall. Second, and especially important in practice, retaining earnings in a low-tax environment creates a tax-deferral opportunity. With the US corporate rate approaching 40%, Ireland has become a popular location for US multinationals seeking to defer tax.[22]

The US is giving active consideration to ending her traditional policy of taxing corporations on a worldwide basis. If that happens then the national-interest case for corporate tax cuts elsewhere in the world will become even stronger.[23]

Ireland vs the European Commission

Irish fiscal developments need to be seen against a backdrop of initiatives by Ireland to attract FDI

in the face of persistent pressure by the European Commission on Ireland to harmonise her corporate taxes with those of the rest of the EU. In 1999, after years of stand-off—if not actual standover—there was a settlement of sorts. Ireland agreed to phase out taxes that favoured foreign investors over domestic ones by extending to domestic firms the pre-existing tax breaks offered to selected foreign companies. In this way, Ireland moved to comply technically with the EU requirement that there be a level playing field for all companies operating within the borders of each member nation. Yet the settlement has generally been seen as an Irish victory. What the big European countries really wanted was a level playing field brought about by way of hefty tax imposts on foreign companies operating in Ireland.

Conclusion

To the victor the spoils. Particular credit is due to Charlie McCreevy, an influential politician during the time of Ireland's ascent. Before entering the Dáil in 1977, he practised accountancy, a profession which offers a box seat for observing how taxes affect business decisions. As Minister for Finance from 1997 to 2004, he faced down stern criticism from Romano Prodi, President of the European Commission, during most of that period.

McCreevy also had his fair share of domestic critics. Yet he succeeded in persuading the Irish public that business tax cuts would benefit the wider community, not as a consequence of 'trickledown'—a metaphor carrying the improbable connotation that hard-faced men of business are actually careless with assets under their management—but of calculated efforts all round to make the most of investment opportunities created by the Irish tax model. Its resounding success should inspire our Treasurer.

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