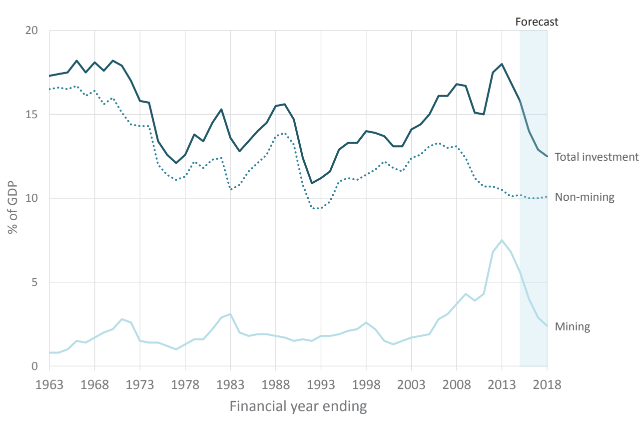
THE LOOMING CRISIS IN BUSINESS INVESTMENT

Cut the company tax rate to boost near-record low investment, argues **Michael Potter**

Australia is facing a major threat from plummeting business investment, which is forecast to hit recessionary levels in a couple of years. As a result, we risk ongoing stagnation of wages, household incomes, productivity and economic growth. And our investment predicament is unusual: Australia's performance is worse than in most other developed countries, even if mining is excluded.

The plunge in mining investment is easily explained by the end of the mining boom. However, the problem is non-mining investment, which is already at recessionary levels as a share of GDP and isn't expected to grow (see Figure 1).

Figure 1: Business investment in Australia (as % of GDP)



Sources: Figures for 1962–63 to 2014–15 are from ABS, Australian System of National Accounts; figures for 2015–16 to 2017–18 are forecasts derived from the 2016–17 Budget.

These investment levels have only occurred once before: in the middle of the 1990s recession when unemployment rose sharply to 11% and there were seven consecutive quarters of declines in GDP per person, a decline of 3.1% per person across almost two years.[1] Non-mining investment is lower today than during the 1980s recession when there were six consecutive quarters of decline, and the 1974 recession when there were three quarters of decline.[2]

Yet GDP per person is growing at about its historical average right now and has grown since the middle of the Global Financial Crisis (GFC) in 2009.[3] Unemployment is currently at moderately low levels compared to recent history and has been falling.[4] The economy is stronger today than during every recession since the 1960s, yet investment is currently weaker than in all of those recessions bar the 1990s recession, which was the worst Australian recession since the Great Depression (using unemployment as the measure).[5]

Australia needs business investment—the accumulation of business capital—to maintain and increase wages, incomes and overall living standards. Over the past 42 years, GDP grew in real terms by 244% or 3.1% per year, with capital accumulation contributing 61% of this increase.[6] The economy is 150% larger in real terms today because of investment.

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The importance of foreign investment in particular is shown in a number of economic studies that found:[7]

- Between 1984 and 1989, foreign capital meant Australia's real national income was 15% higher than otherwise.
- A 10% increase in foreign direct investment over the period 2010 to 2020 would increase real GDP by 1.2%.
- Conversely, a reduction of foreign capital inflow and investment of 1% of GDP would reduce Australia's national income by about 0.5% each year over a ten year period.

What is surprising is that investment (whether locally or foreign financed) is shrinking despite record low interest rates. The Reserve Bank of Australia (RBA) has—in its own cautious way—expressed surprise at this weakness: the minutes of the October 2016 RBA Board meeting stated: 'Growth had been broadly based and supported by strong growth in public demand. However, non-mining investment had been little changed over the past few years even though survey measures of business conditions and capacity utilisation had remained above their long-run averages.'[8]

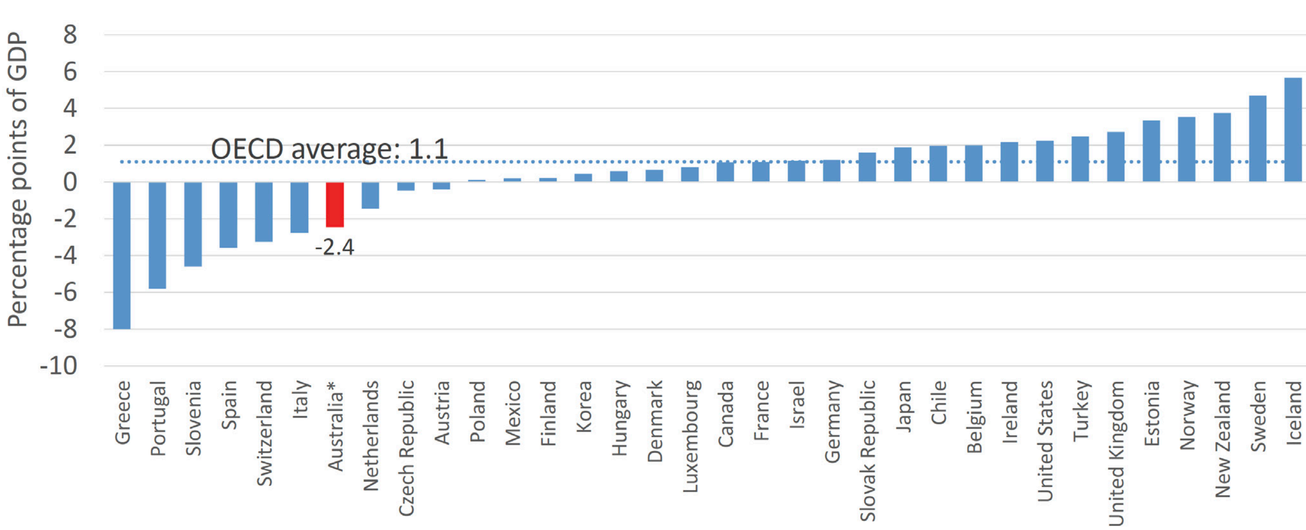
International comparisons

The obvious explanation for weak investment is global: businesses in many other countries have been cutting investment since the GFC. However, this explanation doesn't work. According to IMF data, investment fell as a share of GDP in Australia by 2.4 percentage points from 2009 to 2016, if mining is excluded. However, investment across all developed countries increased by 1.1 points of GDP and investment across the globe increased by 2.2 points.

There are other countries with larger falls in investment than Australia, in particular Portugal, Italy, Greece and Spain.[9] These are the so-called PIGS countries that have been subject to major economic declines since the GFC. In particular, real GDP per person in Greece has fallen by 25% since the GFC.[10] But Australia's decline in investment isn't far behind the decline in Italy (see Figure 2). These are not economies that we should wish to be compared to.

Adjusting the IMF data to remove mining from Australia's figures, there are only six other countries in the OECD that have a worse investment performance since 2009: Slovenia and Switzerland plus the previously-mentioned PIGS countries. All other OECD countries have performed better than Australia, as shown in Figure 2.

Figure 2: Change in investment to GDP ratio in OECD from 2009 to 2015



Source: IMF *World Economic Outlook*, *October 2016*. Figures are on a calendar year basis. For Australia, figures exclude mining; similar results hold if mining is included. The start year of 2009 was chosen because this was when the investment to GDP share hit its lowest post-GFC level in the OECD. The results are similar if a start year of 2010 is used, or an end year of 2016 is used (based on IMF forecasts), or both.

These IMF figures include both private and public investment. But Australia's poor performance can't be excused by a decline in public investment, which only fell by 0.3 points from 2009 to 2016.[11] So most of Australia's decline is caused by weakness in business investment.[12]

Australia continues to run a current account deficit, so we are attracting capital from overseas.[13] However, the flows are not so much going into business investment but rather into other assets such as property.[14]

Plausible explanations for the ominous investment situation

There are several potential explanations for the weakness in Australian non-mining business investment. However, none of these can explain Australia's weak performance *relative* to other developed countries. The supposed reasons could include:[15]

- Increased competitive pressures on businesses may be causing reduced investment. It is argued that globalisation and the internet are reducing the pricing power of many businesses,[16] a point with merit. It is a logical explanation for low inflation in Australia and other developed countries. This reduced pricing power may be discouraging business from investing. However, there are no indications that competitive pressures are much greater in Australia than in other developed countries. In addition, there is some evidence that increased competition may increase not reduce investment.[17]
- Investment may be lower because of poor economic growth (both current and forecast). However, this cannot be an explanation for Australia, because our growth rate is *higher* relative to other developed countries, as are the forecasts.[18] Similarly for excess or idle capital: Australian business capacity utilisation is above long-run averages[19] while excess capacity appears to be substantial in the rest of the world;[20] and Australia's unemployment rate is below OECD averages.[21]
- The new economy may require less capital—for example, Uber and Airbnb can operate with relatively minimal capital.[22] However, there is no reason to believe that this explanation applies to Australia more than other developed countries.
- Investment may be down because of increased aversion to risk and an increased desire for security.[23] But again it is not clear that Australia is a much more risky country or more risk-adverse than other developed economies.

In addition, business investment should actually be increasing in Australia relative to other developed countries because the substantial falls in the Australian dollar since the end of the mining boom have made our economy more competitive and therefore a better location for investment. However, the opposite is occurring.

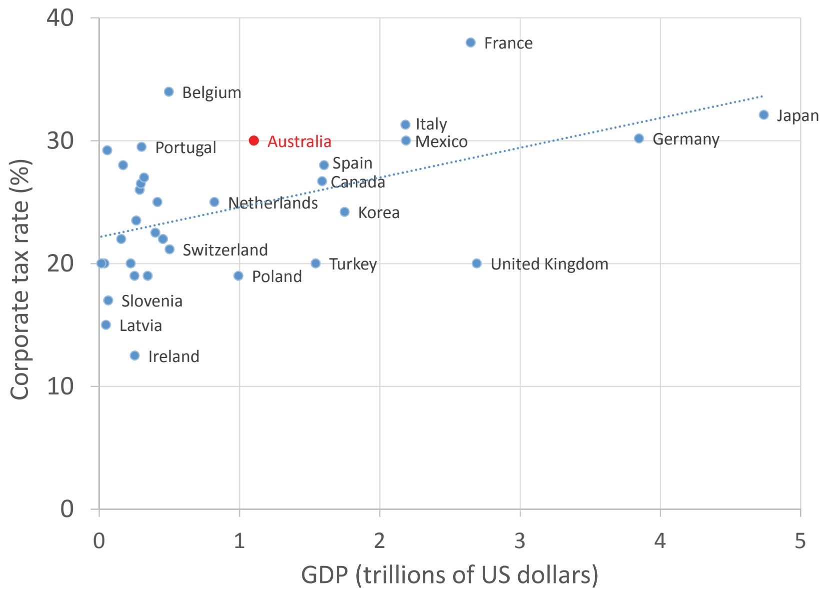
One possible explanation for low business investment is the higher interest rates in Australia compared with many other countries (despite the substantial falls in our rates). However, this is unlikely to explain much because business investment is separate from investment in bonds and other interest-bearing assets.

A better explanation

The best remaining explanation for Australia's poor investment performance is that Australia is an uncompetitive investment location, despite the falling dollar. The returns on investment are not sufficient compensation for the costs of investing. Some broad measures of Australia's competitive decline include the following:

- The World Economic Forum has Australia's Global Competitiveness ranking falling from 16th in 2007 to 21st in 2016.[24]
- The International Institute for Management Development's World Competitiveness Yearbook has Australia's ranking falling from 5th in 2010 to 17th in 2016.[25]
- The Heritage Foundation Index of Economic Freedom has Australia's score declining by almost three points from 2012 to 2016. Over the same period, the world average freedom score has increased by almost one point.[26]
- The Fraser Institute's Economic Freedom of the World index shows Australia's ranking falling from fifth in 2010 (the highest ranking Australia has achieved) to tenth in 2014.[27]

Figure 3: Relationship between company tax rate and economy size for OECD excluding US



Sources and notes: Potter (2016).[29]

One of the key components of competitiveness is tax, and a particularly uncompetitive part of Australia's tax system is the tax on investment or company tax. This was a key focus of my October 2016 CIS research report *Fix It Or Fail: Why We Must Cut Company Tax Now*,[28] which explained the case for cutting the company tax rate to 25%.

Australia's company tax is uncompetitive

Australia's company tax rate is well above the average for a country of Australia's size: analysis from my report (in Figure 3 above) shows Australia's company tax rate, currently 30%, would be expected to be between 24.5% and 24.8% based on the size of our economy (depending on whether the US is included).

The reasons why smaller countries tend to have lower company tax rates include:[30]

- Foreign investment is more sensitive to the company tax rate in smaller countries;
- A greater proportion of economic activity is internationally mobile in smaller countries (while businesses in larger economies are somewhat more domestically focused); and
- larger countries have (slightly) more influence over the global price of capital.

My report also noted that:

- The supposedly high-taxing Nordic countries have much lower company tax rates than Australia, with Sweden's company tax rate at 22%, Finland at 20%, Denmark at 22%, Iceland at 20% and Norway at 25%.[31]
- The trends are for significant declines in company tax rates over time. Australia last cut its company tax rate in 2001. Since then, 32 out of 35 OECD countries have cut their company tax rate, with the weighted average rate falling by 5.7 percentage points. Australia's rate remained unchanged over this period.
- If trends continue, the weighted average OECD corporate tax rate will still be lower than Australia's, even after our tax rate is cut to 25% in 2026–27 as proposed.
- Our current company tax rate of 30% is well above the Asian average of 22% and the global average of 23.6%.

The revenue from Australia's company tax is also highly uncompetitive:

- Company tax revenue as a share of GDP in Australia is the second highest in the OECD.

At 4.9% in 2013, it was almost double the weighted average of 2.6%.

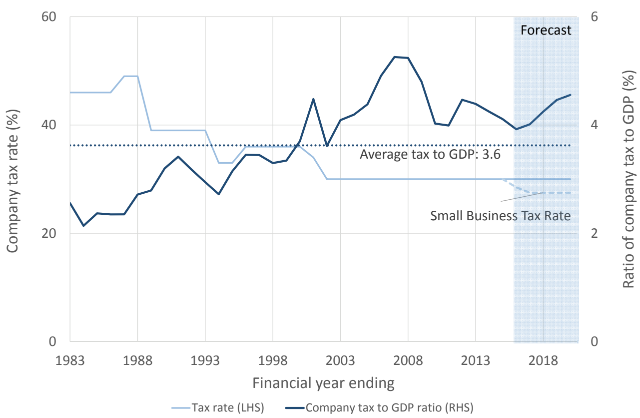
- Australia's effective rate of tax on companies, or tax as a share of profits, is well above global, developed world and Asian averages.
- Australia's tax system relies much more on company tax than other developed countries: the reliance in Australia is the third highest in the OECD and is significantly above the OECD weighted average.

Increasing tax burden over time

Not only is our company tax system currently uncompetitive, but also the burden of this tax is forecast to grow strongly.

The main tax on investment, through company tax, is set to increase quickly as a share of GDP (see Figure 4 below). This ratio is currently above the historical average, and is forecast to increase strongly to reach boom levels in three years time. The ratio in 2019–20 will approach the ratio from the middle of the mining boom.

Figure 4: Company tax to GDP ratio for Australia—history and forecasts



Source: Potter (2016).[32] The average is from 1982–83 to 2015–16. I show similar results occur if the ratio of tax to profits is used, see Potter (2016).[33]

So, in a particularly unfortunate juxtaposition, business investment is forecast to fall to recessionary levels while the main tax on investment—company tax—is forecast to reach boom levels.

How a company tax cut will help

It should be obvious that a cut in company tax will result in more investment. However, there is some scepticism about this link. My research report addressed these concerns by citing a wide body of real-world evidence showing the substantial benefits of company tax reductions in Australia and other countries. These benefits include gains to foreign investment and overall investment, wages, GDP and productivity.

> The company tax cut does not need to be financed by bracket creep, as has been suggested.

The substantial boost to investment from the proposed company tax cut to 25% should lead to an increase in GDP, which then improves other economic outcomes. Treasury modelling of the tax cut shows an expected gain to household income is equal to more than one full year of growth in that measure while the gain to wages is equal to around a half-year's growth; similarly, productivity is expected to be boosted by around a half-year's growth (based on current growth rates of these figures).[34]

My report analysed the funding of the tax cut, noting that the boost to the economy is smaller if there is an accompanying hike in personal income taxes. As a result, it is better that the cut isn't funded by higher personal taxes. Instead, the cut in the tax on investment can—and should—be financed by the main tax measures in the 2016–17 Budget: the superannuation changes, the increase in tobacco taxes, and measures to reduce tax avoidance.[35] This means that the company tax cut does not need to be financed by bracket creep, as has been suggested.[36]

If more funding is required, then cancelling the proposed increase in the superannuation guarantee (SG) from the current level of 9.5% to 12% will bring in additional revenue of an estimated $2.2 billion. The SG increase is also expected to lead to a reduction in GDP, wages, employment and even investment, as I argued in the Spring 2016 edition of *Policy*.[37] All these effects are contrary to the expected outcomes of the company tax cut.

Myths of the company tax cut

Numerous myths have been promoted about the proposed company tax cut. Five of the most widespread myths are debunked below. A fuller discussion of these and other myths—for instance, claims that imputation means Australia's tax system is competitive—can be found in my report.

Myth 1: companies shouldn't get a tax cut because there is so much tax avoidance

- Companies paying full taxes have nothing to do with supposed tax avoiders and shouldn't be penalised for the unrelated 'sins' of other firms.
- Australian companies pay much more tax than the OECD average, and the Australian Taxation Office says there is no evidence of widespread tax avoidance.
- Cancelling the tax cut will encourage an increase in tax avoidance.
- Measures are being taken to address tax avoidance and the funds raised will help pay for the tax cut.

> Government investment is not a close substitute for private sector investment. The dire forecast for private investment can't be solved by government.

Myth 2: the benefits of the tax cut are small compared to the costs

- Treasury has argued the benefits are substantial; they are similar to the gains from the major infrastructure reforms in the 1990s, and these gains aren't criticised for being 'too small'.
- Treasury modelling indicates sizable gains to GDP, wages, incomes, investment and productivity *after* costs are subtracted. These gains are supported by detailed studies of international evidence published in highly regarded journals.
- The benefits are underestimated. The modelling assumes that the only benefit to investment comes from foreigners, when in fact Australian-financed investment is likely to grow as well.

Myth 3: the funds for the tax cut should be spent on education, infrastructure or other policies

- The tax cut can be fully funded from the tax increases in the 2016–17 Budget, so it doesn't preclude any other policy from being implemented.
- The policy has large benefits relative to costs; other policies should go ahead if they can similarly demonstrate benefits much larger than costs.
- Government infrastructure spending has questionable benefits, as discussed opposite.

Myth 4: the tax cut provides a big windfall to foreigners/big business

- Treasury finds that most of the benefit will ultimately go to workers.
- In the longer term, the benefits to foreign investors and the US Treasury will be small.
- The policy generates considerable benefits to Australians; any benefits to foreigners should be seen as a bonus. Put another way, benefits to foreigners should *increase* support for a policy, just as collateral damage to foreigners should reduce support.

Myth 5: the tax cut will cause national income to decrease, based on modelling by Janine Dixon for Victoria University's Centre of Policy Studies

- Dixon's modelling implies foreign investment hurts Australia, which is contradicted by the evidence. Australia is built on foreign investment.
- The modelling is of a different policy, not the government's policy.
- Dixon's modelling, like the Treasury modelling, underestimates the benefit of the tax cut by assuming that Australian-financed investment doesn't increase due to a tax cut.

In October, the Senate Standing Committee on Economics concluded an inquiry into the proposed company tax cut (the Enterprise Tax Plan bill). The inquiry's majority report—which extensively cited arguments from my CIS report—recognised that Australia's comparatively high company tax rate discourages international investment and that the tax cut is needed to increase non-mining investment (which is at recessionary levels) and hence wages, jobs and growth. Therefore the Committee recommended that the bill be passed.[38]

An alternative option: increase government investment

The weakness in business investment is likely to result in calls for increased government or public sector investment. However, there are reasons to be sceptical about this alternative:

- Government investment is not a close substitute for private sector investment. The dire forecast for private investment can't be solved by government.
- While government investment is valuable in theory, the results are different in practice. Some of the largest government investments are not worthwhile and cause a net loss to society. For example, a cost-benefit analysis of the National Broadband Network showed the Coalition's preferred model would have net costs of $6 billion (the Labor Party's preferred model had net costs of $22 billion).[39] The Australian Capital Territory (ACT) light rail only shows a net benefit by incorporating extraordinarily large estimates of non-transport benefits,[40] an approach that has been questioned by the ACT Auditor-General.[41]
- Most government infrastructure projects suffer from large cost blowouts. For example, transport infrastructure projects over the last 15 years blew out on average by 24% compared to original cost forecasts.[42]

Conclusion

Australia is facing a critical business investment shortage. Our investment levels are noticeably down since the GFC, a worse performance than most other developed countries. This problem remains even after adjusting for the impact of the mining boom.

There are a number of plausible explanations for investment levels across the developed world, but none of them can justify Australia's relatively poor performance. The Australian economy is becoming less competitive for business investment, particularly due to the uncompetitive Australian company tax system. Our company tax imposes a burden on companies well above the developed world average, even when imputation is subtracted.

To address this situation, a reduction in the tax on investment, through a cut in the company tax rate, is essential. Not only is it expected to boost investment, it is also expected to lead to growth in wages, incomes, GDP and productivity. But if nothing is done, Australia risks stagnation in all these measures. It is not a future we should wish for.

Endnotes

1 In trend terms, for the March 1990 quarter to September 1991 quarter inclusive. Source: Australian Bureau of Statistics (ABS), Australian National Accounts: National Income, Expenditure and Product, Cat No 5206, June 2016.

2 All figures are GDP per person in trend terms. Source: ABS, Australian National Accounts.

3 Source: ABS, Australian National Accounts.

4 Source: ABS, Labour Force, Australia, Cat No 6202, September 2016.

5 Unemployment in 1993 reached 11%, and was lower than 11% in every year between 1937 and 1992. Source: Matthew Butlin, Robert Dixon and Peter Lloyd, 'Statistical Appendix: Selected Data Series 1800–2010', in Simon Ville and Glenn Withers (eds), *The Cambridge Economic History of Australia* (Melbourne: Cambridge University Press, 2015).

6 Author's calculation based on Table 4 of ABS, Estimates of Industry Multifactor Productivity, Australia, 2014–15, Cat No 5260.0.55.002 (2015).

7 Box 12.1 of Productivity Commission, *Regulation of Agriculture* (Canberra: Productivity Commission, 2016).

8 Reserve Bank of Australia, *Minutes of the Monetary Policy Meeting of the Reserve Bank Board* (Sydney: RBA, 4 October 2016).

9 Source: International Monetary Fund (IMF), *World Economic Outlook, October 2016* (Washington DC: International Monetary Fund, 2016).

10 Source: as above. Real GDP per person from 2007 to 2015.

11 These figures are on a financial year basis. Source: Table 36 of ABS, Australian System of National Accounts, 2015–16, Cat No 5204.

12 The IMF and OECD do not have estimates for public investment for 2016. The OECD has total public investment as a share of OECD GDP declining from 2009 to 2014 (the latest year available), so this again can't explain Australia's weak performance relative to the OECD. Source: OECD.Stat, *Government at a Glance*, available from: https://stats.oecd.org/Index.aspx?DataSetCode=GOV

13 ABS, Balance of Payments and International Investment Position, Cat No 5302, June 2016.

14 As shown by strong price growth. ABS, Residential Property Price Indexes: Eight Capital Cities, Cat No 6416, June 2016; and CoreLogic Home Value Index, available from: http://www.corelogic.com.au/research/monthly-indices.html

15 See also Kevin Lane and Tom Rosewall, *Firms' Investment Decisions and Interest Rates*, Reserve Bank Bulletin, June Quarter 2015 (Sydney: Reserve Bank, 2015).

16 Philip Lowe, *Inflation and Monetary Policy*, Address to Citi's 8th Annual Australian and New Zealand Investment Conference (Sydney: 18 October 2016).

17 Antonio Ruiz Porras and Celina López-Mateo, 'Market Concentration Measures and Investment Decisions in Mexican Manufacturing Firms', *Accounting & Taxation* 2:1 (2010), 59-69. This study finds that competition-enhancing regulatory changes promote investment: Alberto Alesina, Silvia Ardagna, Guiseppe Nicoletti and Fabio Schiantarelli, 'Regulation and investment', *Journal of the European Economic Association* 3:4 (2005), 791–825. See also Jerome Mathis and Wilfried Sand-Zantman, 'Competition and Investment: What Do We know from the Literature?', *Rapport* IDEI 31 (2014).

18 IMF, *World Economic Outlook, October 2016*, and OECD, *Economic Outlook and Interim Economic Outlook*, available from: https://data.oecd.org/gdp/real-gdp-forecast.htm

19 Reserve Bank of Australia, *Statement of Monetary Policy* (August 2016), 3.

20 Lowe, *Inflation and Monetary Policy*.

21 IMF, *World Economic Outlook, October 2016*, and OECD Forecasts.

22 Lawrence Summers, 'The Age of Secular Stagnation: What It Is and What to Do About It', *Foreign Affairs*, March/April 2016.

23 Lowe, *Inflation and Monetary Policy.*

24 World Economic Forum, *Global Competitiveness Report 2015-2016* (30 September 2015).

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27 James Gwartney, Robert Lawson, and Joshua Hall, *Economic Freedom of the World: 2016 Annual Report* (Canada: Fraser Institute, 2016).

28 Michael Potter, *Fix It Or Fail: Why We Must Cut Company Tax Now*, CIS Research Report 20 (Sydney: The Centre for Independent Studies, October 2016).

29 As above, 5.

30 Céline Azémar, Rodolphe Desbordes and Ian Wooton, 'Country Size and Corporate Tax Rate: Rationale and Empirics', CEPR Discussion Papers 10800 (2015); and Davide Furceri and Georgios Karras, 'Tax Design in the OECD: A Test of the Hines-Summers Hypothesis', *Eastern Economic Journal*, 37:2 (2011), 239-247. See also page 8 of Christopher Heady, *Directions in Overseas Tax Policy*, Paper presented to Melbourne Institute's Australia's Future Tax and Transfer Policy Conference (2010).

31 Source: OECD Revenue Statistics. Figures are for 2016.

32 Potter, *Fix It Or Fail*, 8.

33 As above, 9.

34 For National Income and Productivity, source: ABS, Australian National Accounts: National Income, Expenditure and Product, June 2016, Cat No 5206. For Wages, source : ABS, Wage Price Index, Australia, June 2016, Cat No 6345.

35 These measures combined have an estimated long-run impact almost exactly equal to the long-run cost of the company tax cut, as shown in Potter, *Fix It Or Fail*, 19 (see note 28).

36 David Uren, 'Company Tax Cuts "Make Bracket Creep Inevitable"', *The Australian* (20 September 2016).

37 Michael Potter, 'Don't Increase the Super Guarantee', *Policy* 32:3 (Spring 2016), pp. 27-36.

38 The Senate, Economics Legislation Committee, *Treasury Laws Amendment (Enterprise Tax Plan) Bill 2016 (Provisions) –Report* (Commonwealth of Australia, October 2016).

39 Michael Vertigan, Alison Deans, Henry Ergas and Tony Shaw, *Independent Cost-Benefit Analysis of Broadband and Review of Regulation*, volume 2 (2014), 10. Costs are relative to the unsubsidised rollout of broadband.

40 Leo Dobes and Joanne Leung, 'Wider Economic Impacts in Transport Infrastructure Cost-Benefit Analysis–A Bridge Too Far?', *Agenda* 22:1 (2015).

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