RESEARCH REPORT
SNAPSHOT

THE CENTRE FOR INDEPENDENT STUDIES

Fix it or fail: Why we must cut company tax now

Michael Potter

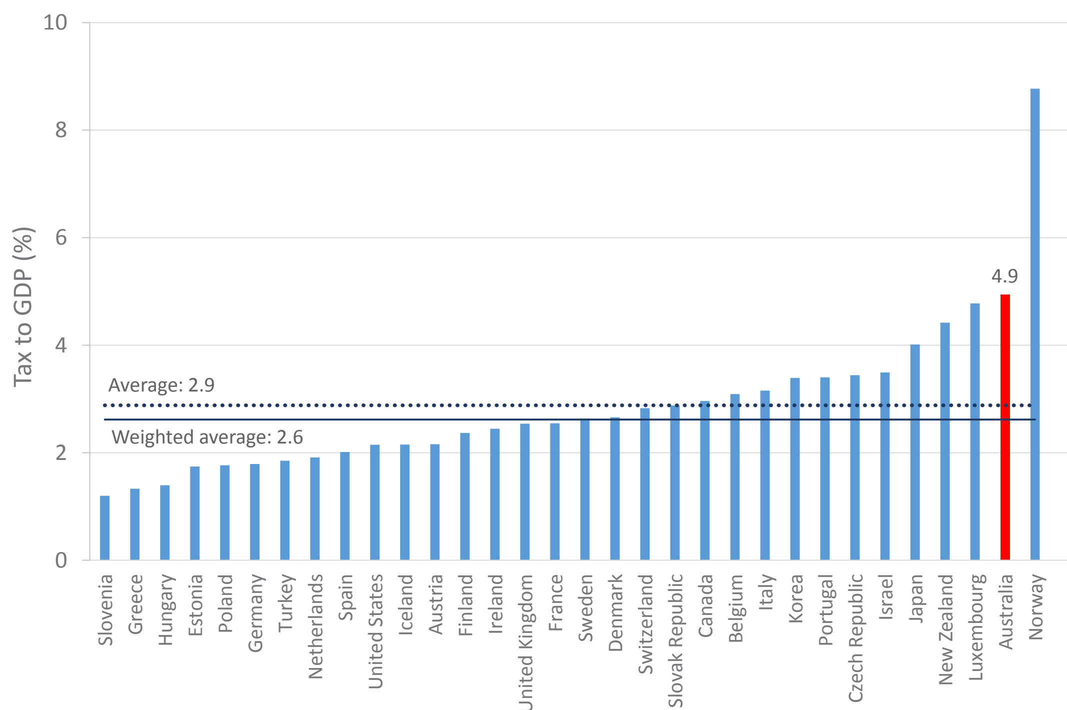
The Australian economy has major structural weaknesses. And if we fail to fix these weaknesses, we risk failure: stagnant growth in wages, incomes, productivity and GDP.

- Business investment is at near-record lows. It has been lower only once: in the depths of the 1990s recession. Mining investment is plummeting and is not being replaced by non-mining investment.
  - There are enormous amounts of global capital, but it isn't going to Australian business investment.
- Productivity growth is weak and national income growth is near zero. Wages growth is at or near record low levels.
- Australia's economic growth rate cannot be sustained without boosting investment and productivity. These are the *only* ways we can get sustained growth in household incomes given we are expecting long-term declines in labour force participation.
- The Budget deficit is being cut mainly by increases in personal and company tax. A structurally unsound economy is being hit with substantial tax increases.

Australia's company tax is very uncompetitive:

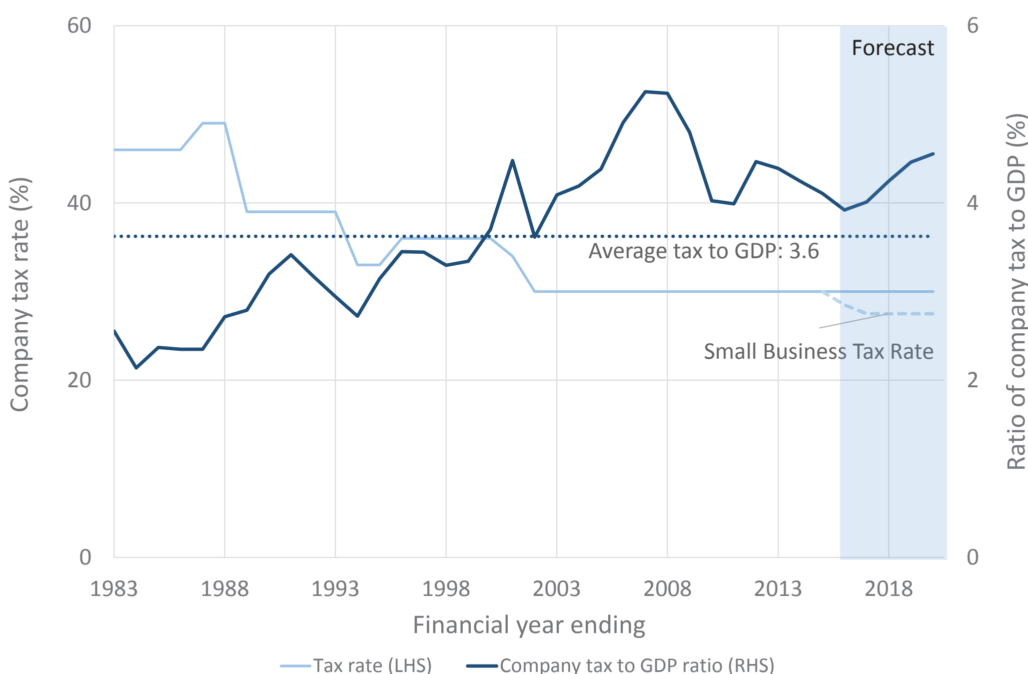
- Our company tax rate is above OECD averages, particularly when taking account of the size of our economy.
  - Australia's tax rate is well above what should be expected for a country of our size.
- Almost all OECD countries have cut their corporate tax rate since 2001: the average decline is 6–7 percentage points. In contrast Australia's rate has remained unchanged.
  - If trends continue, our tax rate will still be above the average even after the tax cut is fully implemented.
- Australian companies pay more tax than OECD averages, as shown in the figure below. This holds even when imputation *and* the proposed tax cut are subtracted.

Company tax to GDP ratio in OECD, 2013



- Our tax rate is well above global and local averages and these international averages have been declining over the last 10 years, while Australia's rate has remained unchanged.
- In addition, Australia's effective tax rate on companies (tax as a proportion of profits) and the share of total revenue coming from company tax are both well above OECD averages.
- Australia's ratio of company tax to GDP is above its historical average and set to grow strongly. This is shown in the graph below.
- Company tax revenue is set to reach levels only reached once before — in the middle of the mining boom. And investment is expected to be at levels only reached once before — in the depths of the 1990s recession.
    - With dismal investment levels, we should not be hitting investment with such a large tax increase.
- Australia is becoming less competitive on many other measures of the regulatory burden; company tax is exacerbating these harmful changes.

Company tax to GDP ratio for Australia — history and forecasts



Cutting company tax is one of the best ways to address our economy's underlying weaknesses:

- The tax cut will encourage more investment into Australian businesses, particularly from foreign investors.
- Increased investment will grow the economy, resulting in sizable boosts to incomes and wages.
- There is widespread agreement that higher investment will grow the economy, as well as promoting competition, productivity and access to innovative technology.

The detailed modelling by Treasury agrees:

- GDP is set to increase by over 1%, a substantial increase as argued by Treasury. It is around the same benefit as wide-ranging infrastructure reforms in the 1990s.
- The gain to wages after tax is expected to be about 1.1%, and household incomes around 0.7%, given the measure need not be funded by personal tax increases or bracket creep.
- The tax cut is expected to increase productivity by up to 1%: a half year's productivity growth will come from this policy alone.
  - This is consistent with the uniform agreement by experts that company tax is the most inefficient tax levied by the federal government. Cutting this tax will make the economy more productive.
- These results are supported by numerous studies of international evidence.
- Nevertheless, the modelling underestimates the benefits of the tax cut, because it assumes companies don't increase locally-financed investment.
  - The modelling assumes that imputation nullifies the effect of company tax on Australians, but this doesn't accord with market valuations or company behaviour.

Other arguments for the tax cut include:

- Company tax revenue is becoming very reliant on a small number of taxpayers, so the budget is highly exposed to the risks of these individual companies. A tax cut will ease this reliance.
- Company tax is like a tariff on imported capital, and should be reformed like these other tariffs.
  - Just as with tariff reforms, the decision to implement the tax cut should be based on the benefit to the whole economy.
- It provides tax reductions to all businesses, not just small business, and there are reasons to expect larger businesses to provide the greater economic benefit.
  - Larger businesses have, on average, recently experienced improved profitability, productivity and employment, and provide more workplace flexibility.

The budget impact of the tax cut is small or zero:

- The economic growth caused by the tax cut will result in an offsetting increase in tax revenue, significantly reducing the costs of the tax cut — and the offset is likely to be larger if the underestimate of investment response is corrected.
- The net cost, after these dynamic benefits, can be offset by measures already in the 2016–17 Budget, making the impact on the budget negligible or zero.
- If the tax cut is abandoned, then the overall tax burden will reach an all-time high in a decade, based on current forecasts.

The tax cut need not be phased in over 10 years:

- Australia needs a boost to investment, productivity and wages today.
- However, it is better for the tax cut to be phased in then for it to be cancelled completely. The phase-in will encourage investment to increase before the tax cuts are fully implemented — but only if the tax cuts are 'locked in'.

Company tax mythbuster

Myth: 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. The taxpaying companies shouldn't be penalised for actions of unrelated companies.
  - Collective responsibility for the 'sins' of others is an anathema to good public policy.
- Australian companies pay much more tax than the OECD average and the ATO says there isn't evidence of widespread tax avoidance.
- Nevertheless, cancelling the tax cut encourages an increase in tax avoidance.
- Many actions are being taken to address tax avoidance and the funds raised by this are helping pay for the company tax cut.

Myth: 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 — these gains aren't being criticised as being 'too small'.
- The 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: The benefits round to zero

- On the same basis, the cost to revenue rounds to zero as well.
- Better analysis indicates the tax cut should make GDP and wages higher each and every year for the rest of time, even after the costs are subtracted.

Myth: the funds for the tax cut should be spent on education 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 happening.
- The policy has large benefits relative to costs; other policies should go ahead if they can similarly demonstrate benefits much larger than costs.

Myth: The tax cut isn't worth doing because the costs are now and the benefits are delayed

- The same argument could be used against investment in infrastructure or education

Myth: 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.
    - Benefits to foreigners should *increase* the support for a policy, just as collateral damage to foreigners should reduce support.

Myth: the tax cut will cause national income to decrease, based on modelling by Janine Dixon

- Dixon's modelling implies foreign investment harms Australia, which is completely 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.

Myth: the modelling unbelievably assumes that tax avoidance will fall dramatically with the tax cut

- Not in the Treasury modelling. This modelling is largely unaffected by tax avoidance assumptions.
- Nevertheless, if tax avoidance is less responsive to tax rates than assumed, then the benefits of the tax cut are likely to be larger not smaller.

Myth: Imputation means Australia's tax system is competitive

- Factoring in the tax cut, as well as imputation, still means the revenue from Australia's company tax is well above OECD averages.
    - Adjusting for imputation is questionable because foreign investors put little or no value on imputation, and foreign investors are most influenced by differences in tax burdens.

Author

Michael Potter is a Research Fellow at the Centre for Independent Studies. He authored the CIS research report *The case against tax increases in Australia: The growing burden* and co-authored (with Robert Carling) *Exposing the Stealth Tax: the Bracket Creep rip-off*. Michael has worked for the Parliamentary Budget Office, the Federal Departments of Treasury, Environment and Prime Minister & Cabinet (where he advised then Prime Minister John Howard on the introduction of the GST). He has also worked as Policy Manager, Economics at the National Farmers' Federation, and Director, Economics and Taxation at the Australian Chamber of Commerce and Industry.

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