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Oligopoly money

How a company tax cut would be wasted on big business

A full third of the benefit of a company tax cut would be enjoyed by just 15 companies in Australia. Once phased in the cut would be worth $6.7 billion per year to these companies. Most of these companies are 'oligopolies' that dominate their markets and have little incentive to reinvest proceeds of a tax cut in jobs and productivity.

Discussion paper

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Summary

The Abbott-Turnbull Government's enterprise tax plan will, if implemented, grant a company tax cut worth $50 billion over 10 years. Supporters claim the tax cut would increase long run investment, innovation and employment. Such claims require close scrutiny especially when the costs of the tax cuts are upfront and the public benefits are 20 years or more in the future.

Together the biggest beneficiaries of the tax cut are the largest 15 listed companies in Australia:

- Commonwealth Bank
- ANZ
- BHP Billiton
- Wesfarmers
- Westfield
- Westpac
- Macquarie
- Rio Tinto
- Woolworths
- Telstra
- National Australia Bank
- QBE Insurance
- Woodside Petroleum
- Scentre Group
- CSL

Collectively these companies stand to gain a third of the tax cut, worth $6.7 billion per year, once it is fully implemented. Yet little of this gain is likely to be put into productive, innovative, job-creating employment:

- The large banks and insurers made nine per cent of taxable company income in 2015, yet made just 1.2 per cent of private investment in Australia.
- Mining investment is dependent on where minerals are and their price rather than changes to company tax.
- Investment by the dominant retailers focuses on gaining advantage over each other, rather than innovation, for example through strategic property purchases.
- Telstra makes little net investment. In the last two years its investment in property, plant and equipment was $5,896 million while its depreciation on property, plant and equipment was almost the same at $5,872 million. If Telstra was a serious investor in innovation, there would be no need for NBN Co.

The reason these firms make few investments that increase innovation, employment or productivity is that they do not operate in truly competitive markets. Many of Australia's key markets are dominated by a small number of companies – 'oligopolies' in economics jargon. Oligopolies are unlikely to change their investment or employment decisions based on a cut in company tax rates.

Economists refer to oligopolies as being 'lazy' - more interested in maintaining their market power than trying to innovate. Investments they do make focus on strategic behaviour and are designed to maintain their market position.

Oligopolies that do undertake innovation usually do so to lower their own costs, in particular by reducing labour costs. Examples of this include ATMs, internet banking and self-serve checkouts. This is unlikely to be the types of innovation that the proponents of the company tax cuts are talking about when they say it will encourage additional employment.

If the aim of the company tax cut is to increase investment and employment much of it will be wasted if it is given to large oligopolies. If the government wants to encourage investment and employment it should focus on reducing the market power of these oligopolies rather than handing them billions in company tax cuts.

Introduction

The Turnbull Government's enterprise tax plan proposes to progressively cut the company tax rate from 30 per cent to 25 per cent over 10 years. Treasury estimates that this will cost the budget about $50 billion over the 10 year period.[1] Part of the justification for this tax cut is that it will encourage investment and innovation that would ultimately lead to higher economic growth and employment.

> [The tax cut would] support businesses to invest more in their businesses, to give employees more hours… that is exactly what our enterprise tax plan is seeking to do.[2]

The government is asking the public to accept that giving this $50 billion to companies is in the public interest; that this money will be more beneficial for the public in the hands of businesses than being used by the government to provide services or to reduce the budget deficit.

If companies in Australia use the $50 billion windfall to invest in their businesses, then the government's hopes may be realised. If, on the other hand, companies pay the money out to shareholders, there would be minimal increase in employment or economic growth.

Furthermore, it is important to look at what kind of investments, if any, companies in Australia would make. If they spend the money on labour-intensive activities and hiring more staff, the benefits of the tax cut could see an increase in employment. If businesses invest in labour-saving technology such as ATMs or self-checkouts, there is no reason to believe employment would increase at all.

This paper looks at who the largest beneficiaries of the company tax cut would be and assesses whether they are likely to make employment-creating investments in their businesses.

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[1] Gribbin et al. (2016) *Budget 2016: Turnbull's corporate tax cuts to cost almost $50 billion over 10 years*

[2] Morrison (2016) *Interview on 7.30, 19 December*

Which businesses benefit from a company tax cut?

While all profitable businesses would benefit from a cut in the company tax rate, the biggest beneficiaries of the government's enterprise tax plan are the top 15 listed companies in Australia. In 2015 these 15 companies paid $22 billion of the $66 billion company tax, shown in Table 1 below.[3] This means that when the company tax cut is full introduced they will receive a third of the benefit of that tax cut.

Table 1: Top 15 listed companies: tax paid

Company	Tax paid 2015 (AU$ million)	Before tax profit 2015 (AU$ million)	Notes
Commonwealth Bank	3,429	12,612	
Westpac Bank	3,348	11,416	
National Australia Bank	2,717	9,080	
ANZ Group	2,144	10,533	
Macquarie Group	899	2,522	
QBE Insurance Group	260	953	
BHP Billiton	4,224	See notes	See notes
Rio Tinto	1,842	See notes	See notes
Woodside Petroleum	122	356	
Wesfarmers	1,004	3,444	
Woolworths	930	3,068	
Scentre Group	30	2,759	
Westfield	(1,093)	1,230	See notes
Telstra	1,787	6,073	
CSL Limited	399	2,040	See notes
Total	22,032	61,524	

Sources: Annual reports of the various companies unless otherwise stated

Notes: Companies listed by market capitalisation in Australia. Separate profit figures for BHP's Australian operations are unavailable. BHP tax paid refers to Australian tax only, converted using BHP's year average and BHP's exchange rate for 2015 of AU$1 = US$0.84. Separate profit figures for Rio Tinto's Australian operations are unavailable. Rio Tinto tax data comes from author estimate based on Rio Tinto (2016) *Tax paid in 2015*, http://www.riotinto.com/investors/taxes-paid-16634.aspx. Westfield's negative tax paid

[3] $66 billion total company tax figure from Treasury (2016) *Budget Papers 2016-17, Budget paper no. 1,* http://www.budget.gov.au/2016-17/content/bp1/download/bp1.pdf, see Table 7: Australian Government general government (cash) receipts.

represents a tax refund. CSL tax data represents author estimate of Australian tax paid based on annual report.

Because the top 15 companies are generally very profitable, they stand to receive a significant slice of the company tax cuts into the future. Table 2 examines the value of the tax cut to each of the top 15 firms based on a hypothetical situation where the full tax cut had been introduced in 2015. It also shows the value of the cut in 2026-27 if the enterprise tax plan is introduced and each company's 2015 profits grow in line with the economy overall.[4] 2026-27 is the final year of the phase in and is the first year where all firms get the full tax cut.

Table 2: Amount of tax cut planned for individual companies

Company	On 2015 figures (AU$ million)	In 2026-27 (AU$ million)
Commonwealth Bank of Australia	571.5	994.7
Westpac Banking Corporation	558.0	971.2
National Australia Bank Limited	452.8	788.2
ANZ Group Limited	357.3	622.0
Macquarie Group Limited	149.8	260.8
QBE Insurance Group Limited	43.3	75.4
BHP Billiton Limited	704.0	1,225.4
Rio Tinto Limited	307.0	534.4
Woodside Petroleum Limited	20.3	35.4
Wesfarmers Limited	167.3	291.3
Woolworths Limited	155.0	269.8
Scentre Group	5.0	8.7
Westfield Corporation	na	na
Telstra Corporation Limited	297.8	518.4
CSL Limited	66.5	115.7
Total	3,855.6	6,711.4

Source: Annual reports and author calculations based on Commonwealth Treasury (2016) Mid-Year Economic and Fiscal Outlook 2016-17.

Table 2 shows that if profits grow in line with the general economy, in 2026-27 the company tax cut will be worth almost $1 billion to the Commonwealth Bank. The big four banks would collectively gain $3.4 billion in that year from the tax cut. The three mining companies (BHP, Rio Tinto and Woodside) can expect $1.8 billion in 2026-27 while Coles (Westfarmers) and Woolworth will receive $281 million in the same year.

[4] Based on latest Treasury projections of nominal GDP - Commonwealth Treasury (2016) Mid-Year Economic and Fiscal Outlook 2016-17, http://www.budget.gov.au/2016-17/content/myefo/download/2016-17-MYEFO-combined.pdf

If the full tax cut had been granted in 2015, the top 15 companies would have gained $3.9 billion, including $1.9 billion for the big four banks and $1 billion for our largest mining companies. If the government is successful in implementing its enterprise tax plan, in 2026-27 it will hand a tax cut of $6.7 billion to the top 15 companies.

While the top 15 listed companies would be big beneficiaries of the tax cut, a closer examination of the companies shows they rarely invest in jobs and innovation and where they have been involved in innovation this has been typically to reduce employment rather than expand it.

Many of these companies are household names in Australia. They are household names because they dominate the industries that they operate in, often with only a small number of competitors. Effectively they are oligopolies – large firms that do not face strong competition.

Oligopolies

Oligopolies and monopolies, like those that dominate many Australian industries, behave differently to the way economists assume firms behave in most economic models. Rather than facing stiff competition for every dollar of profit they earn, they face only a few competitors. As a result, much of their activity is directed at getting a strategic advantage over their rivals and maintaining the barriers to entry that give them extensive market power.

This market power with minimal competition makes these firms highly profitable – as is seen in the examples above, with just 15 firms making a significant share of the profits in Australia. These firms are already highly profitable and so have sufficient cash flow from operating activities to undertake investment and innovation if they chose to.

For these reason oligopolies have been called "lazy".

> … firms in oligopolies can be lazy, living off their cash flow without innovating, and can leverage their market power in one market into other markets, thereby stunting the growth of new technology and handicapping the entrepreneurs who could commercialize it.[5]

Oligopolies tend not to focus their investment spending on innovation that will lead to an expansion and additional employment. When they do focus on investment it tends to be about getting a strategic advantage over their rivals and maintaining the barriers to entry that give them extensive market power.

High barriers to entry mean that the threat of new competitors is low. Oligopolistic markets are characterised by a few very large firms who rarely compete on price.

Rather than competing on price, oligopolies often engage in strategic behaviour to reduce competition. Strategic behaviour is where firms in the market focus on the behaviour of their rivals and consider their rivals reactions when making important decisions like what to sell, how to produce and the price they charge.

This strategic behaviour is a different kind of competition that is not particularly beneficial for consumers and does not lead high levels of technical or scientific innovation. Innovation is risky and has the potential to fail. Successful innovation in an

[5] Baumol et al. (2007) *Good Capitalism, Bad Capitalism and the Economics of Growth and Prosperity* p81

oligopoly is likely to be copied by rivals, which means that any benefits are likely to be small and fleeting.[6]

In short oligopolies are markets dominated by large firms operating with restricted competition. These market characteristics encourage only limited investment and innovation. Oligopolies are generally very profitable and as such, changes in company tax rates are unlikely to change their investment, innovation and employment decisions. Unfortunately it is oligopolistic firms that would benefit most from the government's plans to cut company tax.

[6] An exception to this is innovation that reduces the oligopolies costs, particularly their labour costs. This will be talked about in more detail later in the paper.

Oligopolistic markets

The top 15 companies are by definition the biggest and are in less competitive oligopolistic markets where they wield significant market power. Competition tends to restrict the ability of firms to grow. Large firms are generally only found in less competitive markets.

None of the top 15 listed companies are likely to engage in significant additional investment or innovation despite getting a third of the proposed company tax cut when it is fully implemented. The 15 companies can be broken into 5 broad categories.

Table 3: Top 15 companies by industry

Company	Industry	Notes
Commonwealth Bank of Australia	Banking and Insurance	
Westpac Banking Corporation	Banking and Insurance	
National Australia Bank	Banking and Insurance	
ANZ Group	Banking and Insurance	
Macquarie Group	Banking and Insurance	
QBE Insurance Group	Banking and Insurance	
BHP Billiton	Mining	
Rio Tinto	Mining	
Woodside Petroleum	Mining	
Wesfarmers	Retail	Westfarmers undertakes other business activities
Woolworths	Retail	
Scentre Group	Property	
Westfield	Property	
Telstra	Other	
CSL Limited	Other	

The following sections assess how a cut in company tax rate might affect these industries.

BANKING AND INSURANCE

The industry that would benefit most is banking and insurance. In 2026-27 the large banks and insurers would gain $3.7 billion under the Enterprise Tax Plan. Collectively

the six large banks and insurers made $47.1 billion in profit before tax in 2015, representing around nine per cent of taxable company income in that year.[7] Despite earning such a large proportion of taxable income they did not engage in significant amounts of investment.[8] The nine per cent of taxable income compares to them investing just 1.2 per cent of all private investment in Australia.[9]

Limited competition and the dominance of a few big players make banking and insurance a very profitable business. Economic theory would suggest that this also impacts on investment and innovation. Looking at the limited innovation in banking and insurance market we see that it has tended to be in areas designed to reduce employment levels. Automatic Teller Machines and internet banking are designed so that there is less need for consumers to interact with a person. While this has made it easier for people to access their money and other banking services, the main benefit for the banks and insurance companies has been in reducing their employment. It is likely that this is not the kinds of investment and innovation that the proponents of company tax cuts were talking about when they claimed it would increase employment.

Profitability of the banking and insurance market suggests that banks and insurance companies would not face significant financial constraints on any investment or innovation that they might choose to do. Lowering the company tax rate is therefore not likely to act as an incentive for them to increase investment, innovation and employment.

MINING

The three mining companies in the mining category, BHP Billiton, Rio Tinto and Woodside, paid $6.2 billion in tax in 2015. By 2026-27 they are likely to receive a tax cut of $1.8 billion. Mining has seen significant investment during the recent boom. This investment has been primarily aimed at increasing output during times of high resource prices. This investment has not been designed to improve productivity. In fact productivity in the mining industry collapsed during the recent mining boom.[10] The

[7] ABS (2016)) *5206 - Australian System of National Accounts, 2015-16*, Income account

[8] Investment for the purposes of this paper is the firms spending on new property, plant and equipment

[9] Based on national accounting data for investment spending using ABS (2016) *5206 - Australian System of National Accounts, 2015-16*, expenditure account. The figures are not strictly comparable but nevertheless make a telling point. Even this small investment figure overstates the companies' own investment since some is in plant and equipment leased to customers via 'operating leases'. See examples of this in the annual reports of the Commonwealth Bank.

[10] Richardson et al. (2011) *Mining Australia's productivity*

high resource prices made mining extremely profitable pushing mining companies to increase the capacity to extract minerals at almost any cost.

Investment in the mining industry is cyclical. Resource prices go through large cycles and mining investment rises rapidly during boom times and falls dramatically during down turns. It is these resource price cycles that drive investment decisions and this reduces any role that company tax would play in investment decisions.

During booms mining investment is limited mainly by the availability of resources to construct new mines or expand existing ones. This includes the labour to design and build these mines. As the recent mining boom showed those willing and able to work on remote mining projects could command very high wages. It is doubtful that a lower company tax rate would have had any impact on the amount of investment. In fact it has been argued that the government should have introduced policies to restrict the size of the investment boom as this had negative consequences for non-mining parts of the economy.[11]

During a downturn in resource prices mining investment falls. Lower company tax rates would not induce companies to invest more. When demand for their products decreases, mining becomes far less profitable and mining companies are reluctant to invest to expand their output. The recent boom and downturn in resource prices highlights how unimportant company tax rates are in determining investment decisions. If company tax rates had been five per cent lower through the last resource cycle, investment and employment decisions are unlikely to have changed and the only difference is that the mostly foreign owned mining companies would have had a larger post tax profit.

RETAIL

The retail market is dominated by two big players, Coles (Westfamers) and Woolworths. By 2026-27 these two dominant retailers are likely to receive $281 million in tax cuts. These two players engage in strategic behaviour and the competition between the two is dominated by consideration of the others reaction. It is more difficult to have a clear picture of the investment that occurs at Coles since its results are mixed in with Westfarmers other business activities but we see a clearer picture with Woolworths.

[11] Denniss et al. (2012) *Too much of a good thing? The macroeconomic case for slowing down the mining boom*

Woolworths made a before tax profit of $3.1 billion in 2015 and invested $2.1 billion in property, plant and equipment. Westfarmers made a before tax profit of $3.4 billion and invested $2 billion in property, plant and equipment (the Westfarmer's results include a significant number of businesses unrelated to Coles or retail). While investment is a larger part of the retail market than the banking and insurance market, it is important to note that much of the investment that these two dominant players make relates to attempts to gain an advantage over the other through strategic property purchases. This type of investment has limited benefit for consumers and it is doubtful that it would be influenced by a drop in the company tax rate.

The kinds of innovations that Coles and Woolworths have undertaken in recent years have involved attempts to reduce their need for workers. For example both Coles and Woolworths have rolled out self-serve checkouts. This allows customers to pay for items without having to interact with checkout operators. This is not the type of innovation that the proponents of company tax cuts talk about when they claim that cutting tax rates will increase employment.

PROPERTY

The two companies in the property group are the result of Westfield changing its structure in 2014. Broadly Westfield Corporation owns the Westfield assets and Scentre Group manages them. Neither company pays significant amounts of company tax. In 2015 Westfield Corporation got a tax refund of just over a billion dollars on profits of $1.2 billion. Scentre Group paid $30 million in tax on profits of $2.8 billion. Previous year's results show that these companies paid similar low rates of tax. Since the Westfield companies already pay such low rates of tax, any reduction in the company tax rate is unlikely to induce them into additional investment, innovation or employment.

OTHER

Telstra is one company that on the surface might be expected to undertake considerable investment and innovation. Telecommunications is an industry on the cutting edge of technology. Telstra made a before tax profit in 2015 of $6.1 billion and invested $2.8 billion in property, plant and equipment. In 2026-27 the company tax cut is likely to be worth about half a billion dollars.

But Telstra is the dominant player in the Australian telecommunications market and is able to use that dominance to extract a premium from its customers. In many ways Telstra can be seen as a lazy oligopolist who has done just enough to maintain its

dominant position but it has fallen short of public expectations in the provision of some telecommunication products. A good example of this is fixed line data speeds.

Telstra has been reluctant to undertake the necessary investment in its fixed line network to maintain the network data speeds at levels consistent with world's best practice. This is highlighted in the government's decision to form a state owned and operated data network called NBN Co. The fact that the government has chosen to undertake such a large investment in a private market shows that investment and innovation in the telecommunication market is not at sufficiently high levels.

Telstra's 2016 annual report shows investment in property, plant and equipment was $5,896 million over the last two years while its reported depreciation on property, plant and equipment was almost the same at $5,872 million.

CSL Limited is a biotherapeutic company that dominates the blood products market. This dominance again leads to the firm behaving like an oligopoly. In 2026-27 the company tax cut is likely to be worth $116 million. In 2015 it earnt a before tax profit of $2.1 billion but invested just $414 million on property plant and equipment.

Conclusions

The biggest winners from the government's plan to cut the company tax rate by five per cent are the 15 biggest listed companies. Collectively they are set to get a third of the benefit if the tax cut when it is fully implemented, worth $6.7 billion. But despite a significant proportion of the benefit flowing to these large companies, they are unlikely to change their decisions on investment, innovation and employment. An important purpose of this tax cut, according to its proponents, is therefore wasted on these firms.

They will not make changes to their investment, innovation and employment decisions because they are large oligopolies. Oligopolies are more concerned with maintaining their profitability and gaining a strategic advantage over their limited rivals. Investment and innovation are of little concern to firms in an oligopoly.

If the real intent of the company tax cut is to encourage investment, innovation and employment then there are far more effective methods the government can undertake than wasting tens of billions of dollars on large dominant companies.

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