How will the corporate tax cut be funded?

Briefing paper

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Introduction

The Coalition's proposal to reduce the corporate tax rate will result in a significant loss of tax revenue and, in turn, will have a significant impact on the budget balance.

The government has argued that the loss in tax revenue will be offset, in part, by the increase in economic activity that they believe will flow from the reduction in the corporate tax rate. This activity is assumed to take the form of increased investment, increased employment and higher wages.

While the size of any increase in investment, employment and wages associated with a cut in the company tax rate can be debated, no economist has publicly suggested the impact on employment or national income will be large and none have suggested that that any benefits from such increased activity will be quick to eventuate. Indeed, it is widely assumed that it would take at least 20 years for the full benefits of an increase in activity to occur.

Put simply, both the economic modelling released by Treasury and the public commentary around that model take for granted that a cut in the corporate tax rate will lead to 20 years, or more, of bigger budget deficits than would otherwise be the case.

While the fact that a policy might increase the size of the budget deficit for decades should not be used to dismiss the benefits of such a policy it is interesting note that the net benefits of the proposed corporate tax cuts have not been compared by Treasury to the net benefits of other policy proposals with long gestation periods (eg new infrastructure, investment in education, investment in science and technology or other tax changes designed to stimulate investment such as accelerated depreciation)

What is the direct cost of the proposed corporate tax cut?

$48 billion over ten years; $8 billion per year when fully phased in (as corporate tax payments are deductible against personal income tax payments for Australian citizens this $8 billion figure is net of the increase in personal income tax receipts that inevitably accompany a cut in the company tax cut).

When fully implemented the $8 billion cost of the corporate tax cut will cost more each year than the government currently spends on unemployment benefits.

Who will benefit?

The biggest institutional beneficiaries of the proposed corporate tax cut are the major banks and big mining companies.

However, due to the existence of dividend imputation a cut in the corporate tax rate will not result in an increase in post-tax returns for Australian shareholders. Similarly, due to the existence of 'double-taxation' treaties with countries such as the US, foreign companies who earn profits in Australia and repatriate them to the US (of which there were more than 700 in 2013 according to the IRS) will see no increase in post-tax returns (although the IRS will see an increase in their revenue collections as we reduce ours).

The major beneficiaries of the $48 billion cut will be the owners of foreign owned companies who do not repatriate profits to a country with which we have a 'double tax' treaty. These shareholders, who have already chosen to invest in Australia at the prevailing tax rate, will receive a significant windfall gain. Significantly, Treasury assume that most of the increase in investment which might be expected to flow from the lower company tax rate will occur in more than 10 years' time. In turn, most of the $48 billion cost can be best understood as a windfall to existing foreign investors rather than the cost of encouraging new investment.

Has a cost benefit analysis of the proposed cut to the corporate tax rate been conducted?

No. While major infrastructure projects and policies are often subject to 'cost-benefit analysis' no such analysis has been conducted of the $48 billion corporate tax cut policy. While some economic modelling of the long run benefits of the proposed change has been conducted, a systematic evaluation of the costs and benefits has not been conducted.

A cost benefit analysis would allow citizens to evaluate the timing of likely costs and likely benefits. This is particularly important for evaluating the proposal to cut the corporate tax rate which would deliver an immediate and ongoing reduction in tax revenue and which would only deliver small benefits decades into the future. The fact that a policy or project might one day deliver benefits is not usually advances as evidence that the policy or project should be pursued.

Similarly, Treasury has provided no modelling to compare the costs and benefits of an across the board cut to the company tax rate with other investment incentive policies such as accelerated depreciation or tax credits that flow only to those making new investments.

How will the proposed corporate tax cut be funded?

The Turnbull government has neither documented nor explained how it intends to fund the 'centrepiece' of its 'plan for jobs and growth'. The delayed introduction of the company tax cuts for big business mean that the cost of the proposed cut in the company tax cut will be incur beyond the 4 year time horizon of the Commonwealth budget.

Wont the corporate tax cuts pay for themselves via increased economic activity?

No. While there will be some increase in economic activity associated with the proposed cut in the corporate tax rate, and in turn an increase in some tax revenues, these induced increases in revenue will, according to the modelling commissioned by Treasury, be significantly smaller than the direct cost to the budget of the company tax cuts themselves.

What proportion of the cost of the proposed corporate tax cuts will be 'self funded'?

Neither the Treasurer nor the Prime Minister has directly addressed this question. Economic modelling commissioned by Treasury and released on budget night does, however, estimate that 55 per cent of the $8.2 billion per year cost of the tax cuts could be 'self funded'. The assumptions underpinning this degree of 'self funding', however, warrant careful examination.

For example modelling commissioned by Treasury from Chris Murphy of Independent Economics[1] assumes that cuts to the corporate tax rate lead companies to voluntarily reduce their reliance on international profit shifting to reduce tax. The modelling undertaken for Treasury by Independent Economics assumes that this 'morality dividend' will result in an additional $3.9 billion per year in extra revenue as companies choose not to engage in profit shifting.

To put this into context, of the $4.5 billion in assumed 'self funding' of the corporate tax rate cut the Murphy modelling assumes that voluntary reductions in profit shifting account for $3.9 billion. (Note, we have been unable to replicate the $3.9 billion figure and suggest explanation be sought from Treasury - see below for details).

By way of further context, the Turnbull Government expects to raise around $700 million per year from its recently announced crack down on multi-national tax avoidance.

While the Murphy modelling cites other modellers who have made assumptions about the size of the 'morality dividend' that might accompany a cut in the corporate tax rate, they provide no Australian evidence to support the assumption that underpins the biggest 'benefit' of the company tax cut

If companies do not voluntarily elect to pay $3.9 billion per year more company tax (due to their assumed reluctance to engage in profit shifting) then the degree of 'self funding' of the proposed corporate tax cuts will be significantly reduced and, in turn, the need to increase other taxes, or the budget deficit, will be even greater.

[1]http://www.treasury.gov.au/PublicationsAndMedia/Publications/2016/~/media/ACCEB9F5E157439AAE854A9702D1136C.ashx

It should be recalled that Kerry Packer, to whom the Prime Minister once gave legal advice, famously reminded parliament that:

> "of course I am minimizing my tax and if anybody in this country doesn't minimize their tax they want their heads read because as a government I can tell you you're not spending it that well that we should be donating extra."

And;

> "I have told you that I pay whatever tax I am required to pay under the law, not a penny more, not a penny less"

It would seem that not all business people support the assumption that a cut in the company tax rate will lead to a voluntary reduction in tax minimization.

How will the revenue shortfall associated with the proposed corporate tax cuts be funded?

The Murphy modelling, with its assumption of a $3.9 billion 'morality windfall' requires approximately $4 billion in additional personal income tax collections or spending cuts.

The in house modelling conducted by Treasury makes no mention of the 'morality dividend' and in turn requires approximately $8 billion per year (in today's dollars) in personal income tax increases (or similar size cuts in government outlays) to make the proposed company tax cuts budget neutral.

Bracket creep is the most likely source of funding for the proposed company tax cut

Technical note on the $3.9 billion estimate of the morality dividend

The Murphy modelling details the method by which they have estimated the size of the 'Morality Dividend' which, as we note above, is very large.

We have been unable to replicate this result. One explanation may be that the voluntary reduction in tax shifting that has been assumed to occur has been applied to the entirety of profits earned in Australia rather than just to the profits of multinationals. If this is the case it is unclear why Australian owned companies with access to dividend imputation would engage in profit shifting.