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Company tax cuts
What the evidence shows

International and Australian data on tax rates and macroeconomic indicators provides no support to corporate Australia's 'instinctive' claims that lower company tax rates bring wider economic benefits

Discussion paper

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Summary

A feature of Australia's tax debate is the question of whether to change company tax. Claims from business leaders include:

> Uncompetitive rates of corporate and individual income tax are a recipe for lower economic growth, lower incomes…

> Instinctively, it is really worth looking at ... If you increase the GST and reduce corporate tax, you are undoubtedly going to stimulate some business investment. That is a clear phenomenon.

But these claims rely on assertions rather than data and analysis. In contrast, this paper, which analyses data from Australia and OECD countries, finds no support for claims that reduced company tax leads to improved economic performance. Specifically it shows that:

- There is no correlation between corporate tax rates and economic growth in OECD countries.
- Countries with lower company tax rates have lower standards of living, measured as purchasing power of GDP per capita.

While Australia's corporate tax rate was as high as 49 per cent throughout the 1960s and 70s, it was gradually lowered to 30 percent by the start of the new millennium'. But contrary to the claims above, business investment as a share of GDP has also declined. Small recent increases are due to the privatisation of publicly owned businesses and the mining boom, not lower corporate taxes. As corporate taxes have declined, Australia's rates of growth in real GDP and GDP per capita have also declined.

Some commentators claim corporate tax cuts will lead to higher wages, more jobs and more foreign investment. But on the contrary, Australia's historical data shows:

- Wages and mixed income has declined as a share of GDP as corporate taxes have been lowered.
- Average unemployment rates have risen as company tax rates have lowered.
- Growth in foreign investment as a share of GDP was strongest when Australia's company taxes were highest.

Changes to macroeconomic indicators are driven by many factors, not just corporate tax rates. Across many indicators, however, there is no support for the idea that cutting the company tax rate will lead to tangible benefits in the wider economy.

Introduction

Australia's current tax debate has raised the question of whether to change company tax rates. Some argue that company tax rates are too high. The Business Council of Australia (BCA) regularly makes statements like:

> Uncompetitive rates of corporate and individual income tax are a recipe for lower economic growth, lower incomes…[1]

Other commentators and consultants to big business make similar claims:

> Australia relies too heavily on high personal and corporate income taxes levied on overly narrow bases. This mean tax rates are higher than they should be, which is undermining our competitiveness as a source of foreign investment and skilled workers.[2]

> Let's cut to the chase here: advocating a company tax cut sounds like welfare for plutocrats. And surely the timing is awful given a national debate over whether some companies are paying their fair share anyway? But what if a lower company tax rate benefited Australians by providing growth, employment and higher living standards? What if, by pursuing a selfish agenda, the business community also brought the benefits of prosperity to the table?[3]

Ian Narev, CEO of the Commonwealth Bank of Australia and chair of the BCA's Economic Policy and Competitiveness Committee, has said:

> Instinctively, it is really worth looking at – it certainly needs a really good look. If you increase the GST and reduce corporate tax, you are undoubtedly going to stimulate some business investment. That is a clear phenomenon. If the only lense is what is going to stimulate business, that combination undoubtedly works.[4]

[1] Business Council of Australia (2015) the future of tax: Tax while paper initial submission, August, p 3.
[2] Bassanese D (2015) 'The case for a flat 15% tax rate,' Switzer Daily, 18 November http://www.switzer.com.au/the-experts/david-bassanese/the-case-for-a-flat-15-tax-rate/
[3] Deloitte (2015) Shedding light in the debate: Mythbusting tax reform, at http://landing.deloitte.com.au/rs/761-IBL-328/images/Tax_Reform_Paper_Pdf.PDF, p18
[4] Eyers J (2015) 'CBA chief Ian Narev says upping GST, cutting taxes would fire the economy', Sydney Morning Herald, 14 August. http://www.smh.com.au/business/banking-and-finance/cba-chief-ian-narev-says-upping-gst-cutting-taxes-would-fire-the-economy-20150813-giyvvo.html

It is interesting to note that Narev used the word ‘instinctively’ as if his instincts need no further evidence. But there is indeed ample data available from across the world that can be used to examine the relationship between company tax rates and economic performance. This paper examines the data to determine how company tax rates affect the Australian economy, and examines whether there is indeed a link between a company tax rate and the economic performance of OECD nations.

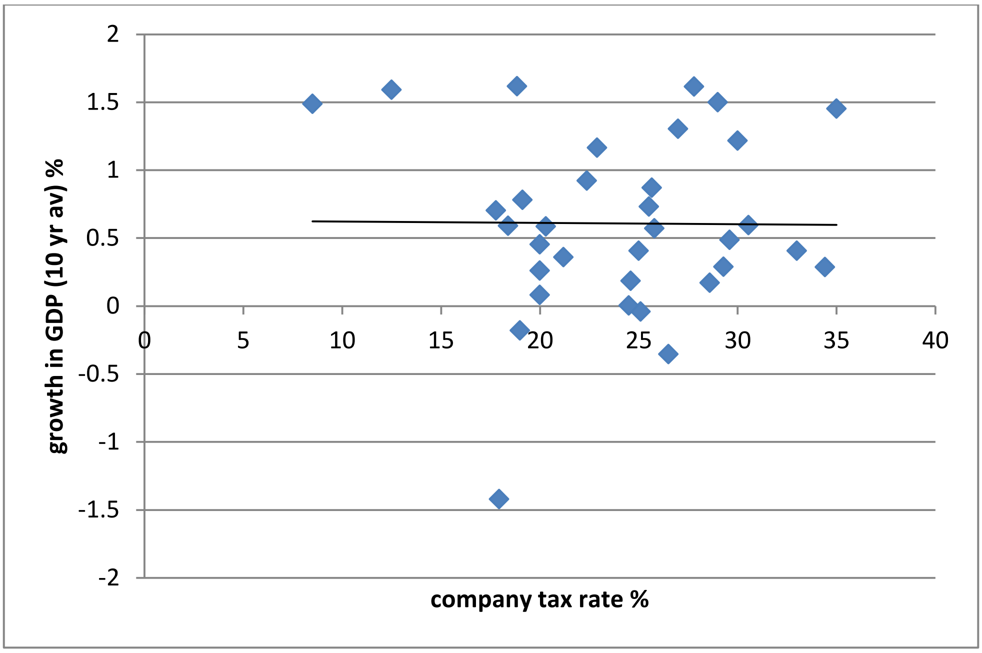
Over the last several decades, Australia has had long periods when the tax rate never fell below 40 per cent, but, more recently, the company tax rate has remained at constant at 30 per cent. By examining these two distinct periods, we can see if there is any evidence that might confirm the tax-cuts-are-good thesis.

Comparisons across OECD countries

We begin our examination of the evidence by looking at the relationship between company tax rates and economic growth across the OECD. Advocates claim that lower company tax rates result in higher economic growth. However, data for OECD countries does not support this claim.

There is no clear relationship between company tax rates and the rates of economic growth in OECD countries, as shown in Figure 1 below:

Figure 1: OECD countries: Company tax rates and economic growth (10 year average)



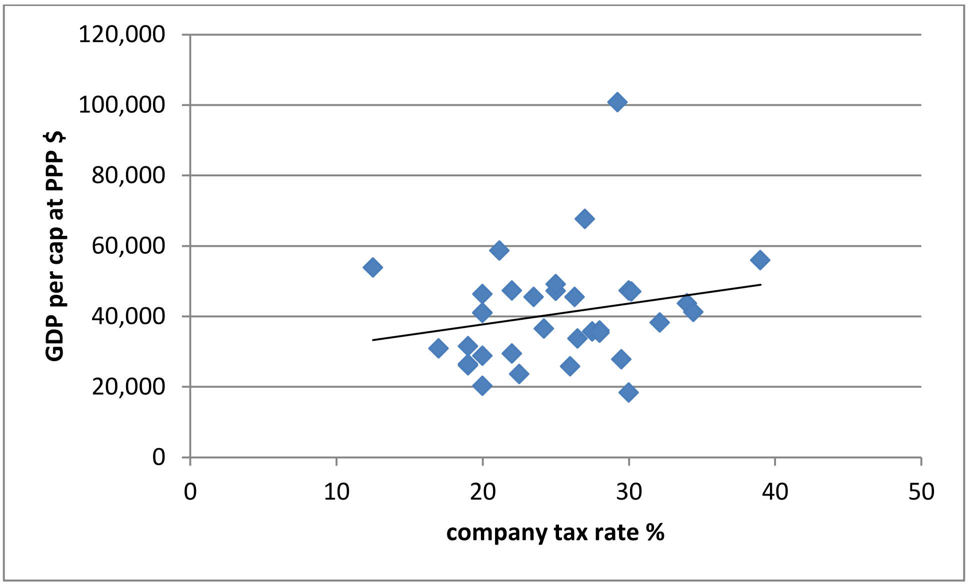
Source: OECD (2016) OECD Tax Database, athttp://www.oecd.org/tax/tax-policy/tax-database.htm; IMF (2016)World Economic Outlook Database at http://www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx accessed 12 February.

Figure 1 compares average annual real economic growth with average company tax rates over the past 10 years. Each point on the graph represents one of the OECD countries. We see that despite the variation in corporate tax rates, from less than 10% (in Switzerland) to 35% (in the US at the Federal level); the trend line is flat. This data gives no support to the claim that lowering company taxes increases economic growth.

Another claim is that lower company tax rates lead to higher living standards. As living standards should be one of the major objectives of economic policy it is important to examine if there is any link between living standards and company tax rates.

Figure 2 examines this proposition. As the measure for living standards we use GDP per capita measured through 'purchasing power parity' (PPP). PPP, overcomes the effects of exchange rates, which fluctuate and obscure the actual differences in living standards, and thus reflects what income earners can actually buy,[5]

Figure 2: OECD countries: Company tax rates and GDP per capita at PPP



Source: OECD (2016) OECD Tax Database, at http://www.oecd.org/tax/tax-policy/tax-database.htm; IMF (2016)World Economic Outlook Database at http://www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx accessed 12 February.

Figure 2 shows that the relationship between company tax rates and living standards is positive – the higher the corporate tax rate, the higher the standard of living. If the proponents of company tax cuts were correct, then we would expect to see countries with lower company tax rates experiencing higher living standards - the trend in Figure 2 should be downward. While we are not arguing that there is any causal link between higher company taxes and higher living standards, we point out that the low tax and higher living standards argument is contradicted by the facts.

We can conclude this section by noting that there seems to be little international evidence in favour of lower company tax rates. At the very least we can say that if there is any link between lower company tax rates and economic growth, it is weak enough to be offset by other factors.

[5] For example if we used market rates and expressed all countries' data in US dollars, Australia's living standards would appear to have fallen dramatically in recent years because of the dramatic decline of the Australian dollar. However, we know that Australia's living standards have not declined. We use the PPP to get rid of the distortion caused by exchange rate fluctuations.

Evidence from Australia's past

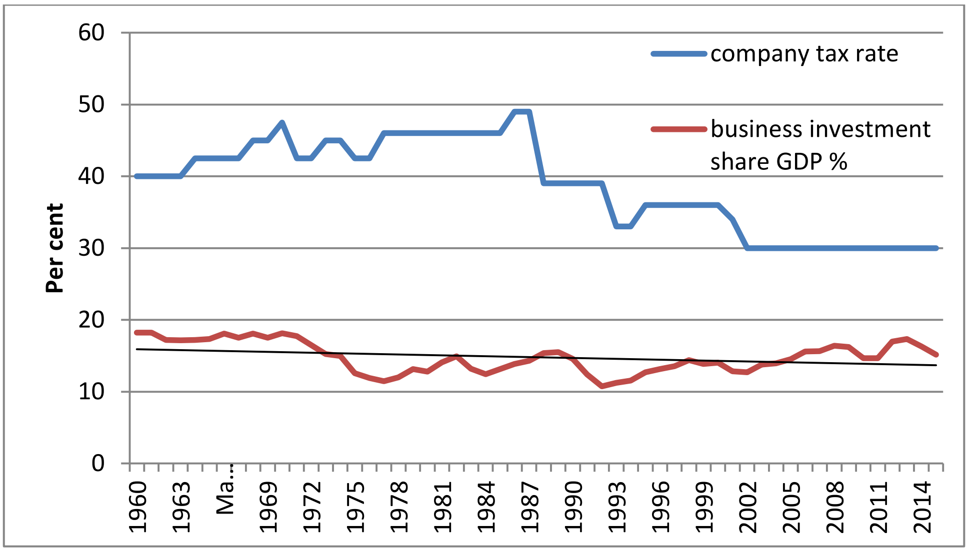
OECD data provides no support to the thesis that company tax cuts deliver economic growth or increased living standards. Australia provides a natural experiment for further examination of these claims, as our company tax rate has changed markedly over the post-war period. We draw our analysis from Australian national accounts data, which go back to financial year 1959-60.

It should be noted that in Australia both the rates of company tax payable and how they apply to different companies changed over time. For much of the period, the company tax rate was different for small and non-resident companies, while retained profits attracted a higher rate.[6] Although we have decided to use the standard rate, it must be borne in mind that for much of the first couple of decades covered by this study undistributed profits were taxed at a higher rate. Company tax rates would have been around 50 per cent for much of the time if this was taken in to account.

A trend line has been added to assist the interpretation of this and subsequent graphs.

We begin by comparing company tax rates and private business investment as a share of GDP, as shown in Figure 3 below:

Figure 3: Company tax rate and private business investment



Source: ABS (2015) *Australian System of National Accounts, 2014-15*. Cat no 5204.0. 30 October and ABS (various years) Year Book Australia, Cat no 1301.0 and Australian Government (various years) *Budget Papers*.

[6] The higher rate on retained profits later became a separate undistributed profits tax.

Figure 3 shows that company tax rates increased between the 1960s and 1988 and then gradually fell to the present rate of 30 per cent. Proponents insist that investment will increase with a cut in the corporate tax rate. Yet the other series in Figure 3 shows that, despite the lower tax rate, business investment as a share of GDP has fallen over the period. Business investment accounted for a higher share of GDP in the decade beginning 1959-60 than it has been ever since the trend line clearly slopes downward from 1960 to 1988 when company tax rates peaked. This is inconsistent with the 'tax-cuts-are-good' thesis.

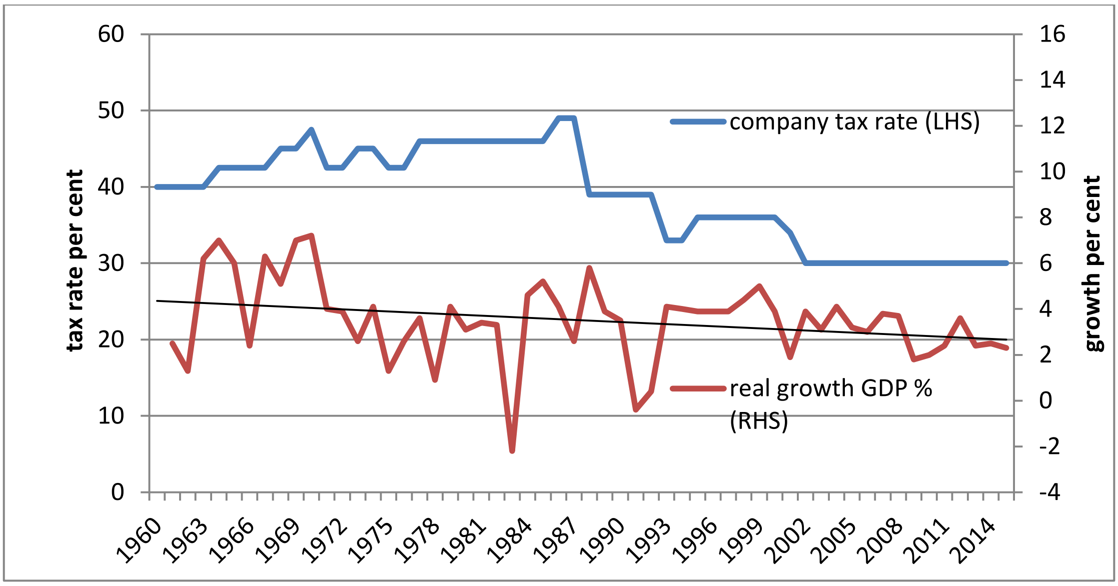
A closer look at Figure 3, reveals that in the period to 1988 investment averaged 14.7 per cent of GDP, while from 2001-02, when the company tax rate was 10 per cent lower, investment averaged 15.3 per cent. At first blush this supports the thesis that lower company tax rates lead to higher investment. However, it is likely that business investment as a share of GDP would have increased from 1988 regardless of the company tax rate for two reasons:

- First, many large corporations moved from the public to the private sector, including Telstra, the Commonwealth Bank, CSL, Tabcorp just to name a few.
- Second, the mining boom, which produced a massive increase in private investment in mining and related industries, took place in the period after the early 2000s. This clearly had more to do with commodity price changes than the company tax rate.

Those two factors would more than explain the apparent increase in the share of private investment during this period. Despite the expectation that investment as a share of GDP should have increased through privatisations and the mining boom, Figure 3 actually shows a slight downward trend. This is further evidence against the 'tax-cuts-are-good' thesis.

We now turn to examine the relationship between the company tax rate and economic growth in Australia. Figure 4 below shows real growth in GDP and the company tax rate in Australia between 1960 and 2015, the latest year for which data was available.

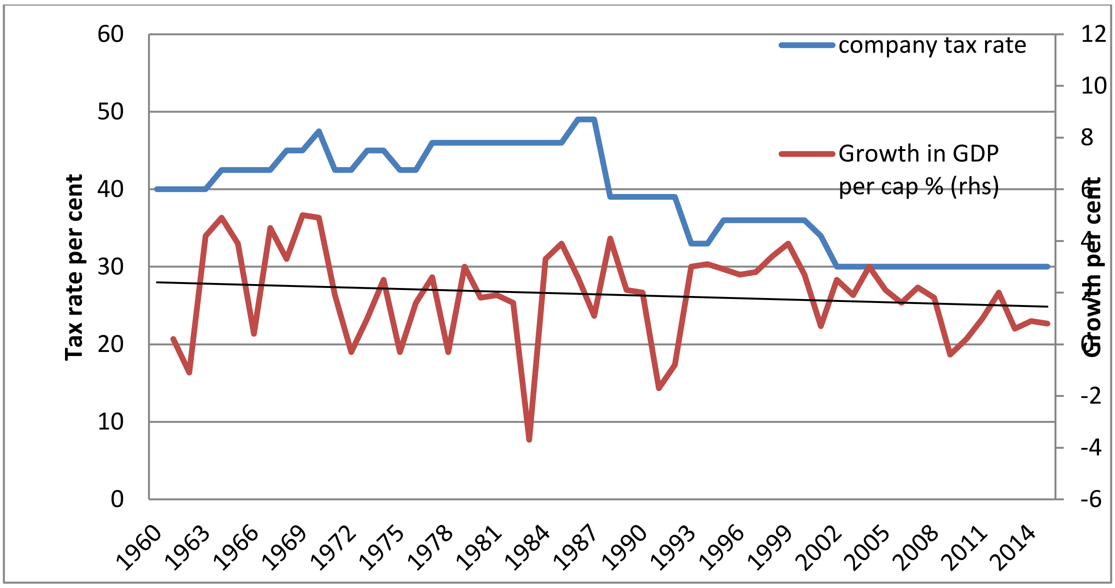
Figure 4: Company tax rate and real economic growth



Source: ABS (2015) Australian System of National Accounts, 2014-15. Cat no 5204.0. 30 October and ABS (various years) Year Book Australia, Cat no 1301.0 and Australian Government (various years) Budget Papers.

As economic growth tends to be very erratic, Figure 4's message is not immediately clear. However, the trend line suggests that growth has declined over the period summarised in the graph. Our analysis of this data shows that economic growth averaged 3.8 per cent in the period to 1988 when corporate tax rates were relatively high, but fell to just 3.0 per cent in the period from 2001-02 when they were significantly lower. Economic growth was almost a full percent higher when company tax rates were 10 per cent higher. Figure 5 examines how GDP per capita evolved over this same period. Figure 5 compares the company tax rate with the annual growth in real GDP per capita.

Figure 5: Company tax rate and growth in GDP per capita



Source: ABS (2015) Australian System of National Accounts, 2014-15. Cat no 5204.0. 30 October and ABS (various years) Year Book Australia, Cat no 1301.0 and Australian Government (various years) Budget Papers.

Figure 5 again shows erratic growth in GDP per capita, and appears to suggest a slightly downward trend. This of course is inconsistent with the proposition that lower company tax rates produce higher living standards. GDP per capital/living standard has/have gradually slowed as the company tax rate has fallen. The average growth in per capita GDP to 1988 was 2.1 per cent, but just 1.4 per cent from 2002 to 2015.

Figure 6 examines how wages, as a share of GDP, have been affected by changes to the company tax rate. This evidence is particularly important because proponents of lower company tax rates routinely argue that a reduction in company tax will lead to increased wages.[7] The idea is that once investors receive their target rates of return after tax, savings will be passed on to the rest of the community through lower prices, leading to higher real wages, and other non-corporate incomes. Hence we have chosen to use compensation of employees plus mixed incomes[8] as a share of total incomes.[9]

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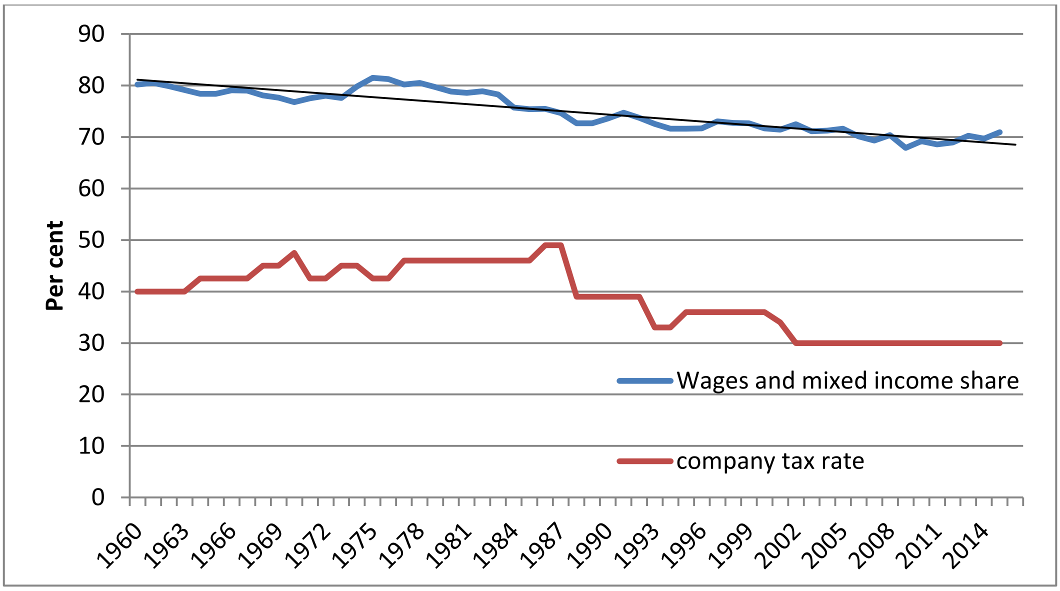
[7] See for example the report of views of the head of Treasury's revenue group in Khadem N (2015) 'Treasury signals company tax cuts', Sydney Morning Herald, 26 March; Deloitte (2015) Shedding light in the debate: Mythbusting tax reform, at http://landing.deloitte.com.au/rs/761-IBL-328/images/Tax_Reform_Paper_Pdf.PDF and Westacott J (2015) 'Start tax debate with right objective: Boosting growth', The Australian Financial Review, 12 November.

[8] 'Mixed incomes' are the incomes of non-corporate businesses including many small businesses, farmers, consultants and the like.

[9] We excluded the government gross operating surplus and the gross operating surplus due to dwellings.

Figure 6: Company tax rate, wages and mixed income share of GDP



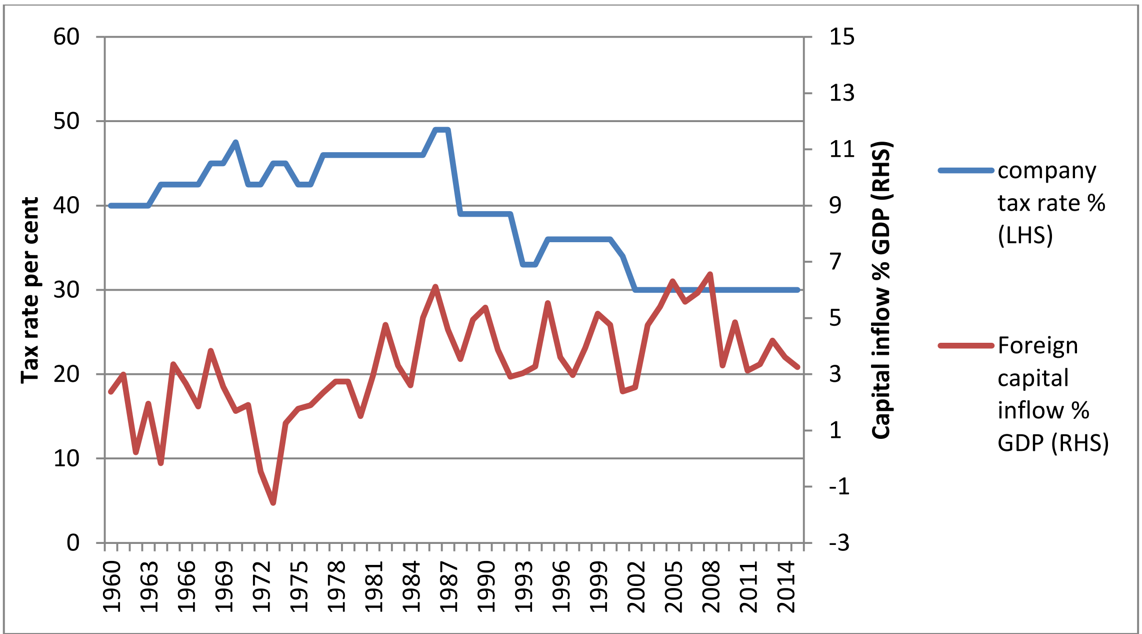
Source: ABS (2015) Australian System of National Accounts, 2014-15. Cat no 5204.0. 30 October and ABS (various years) Year Book Australia, Cat no 1301.0 and Australian Government (various years) Budget Papers.

Figure 6 shows that, despite the steady reduction in company tax rates over the period since the 1980s, wages share of GDP has steadily fallen -, by approximately 13 per cent. That evidence suggests the opposite of the thesis that it is workers who would benefit from the reduction in the corporate tax rate. Indeed one might wonder why the business sector would be so concerned about reducing company tax rates if it is workers that would primarily benefit.

Other data adds further weight to the argument that lower company tax rates are actually bad for wages. For example between 1950 and 1987, when the company tax rate was 40 to 49 per cent, the average unemployment rate was 3.3 per cent. In the period of 30 per cent tax rates since 1 July 2001 unemployment has averaged 5.4 per cent. However, long-term employment and unemployment comparisons are difficult to make as there is a lack of consistency in the definitions used over time.

Another regular argument of the ‘tax-cuts-are-good’ thesis is that foreign investment will increase. That claim can be tested by examining the record of foreign capital inflow as has been done in Figure 7.

Figure 7: Company tax rate and foreign investment as a share of GDP



Source: ABS (2015) Australian System of National Accounts, 2014-15. Cat no 5204.0. 30 October and ABS (various years) Year Book Australia, Cat no 1301.0 and Australian Government (various years) Budget Papers.

The results presented in Figure 7 appear to show that foreign investment increased as a share of GDP in the period to the late 1980s when company tax rates were relatively high. After that, the level of foreign investment remains steady, even as the company tax rate was gradually reduced. This is despite the mining boom, which should have increased the level of foreign investment. Despite this clear evidence to the contrary, some proponents of cutting the corporate tax cite one single OECD report that claims that a one per cent increase in the company tax rate would result in a 3.72 per cent reduction in foreign investment.[10] On that basis a reduction in Australia's company tax from 49 per cent in 1986-88 to 30 per cent by 2002 should have shown up as an increase in foreign investment of 71 per cent (from a bit under five per cent of GDP to over eight per cent of GDP). Figure 7 makes it clear that no such thing occurred. These findings support our earlier observations that company taxes are not a great determinate of foreign investment. Indeed Australia receives a good deal of its foreign investment from countries in Asia and elsewhere that have significantly lower company tax rates.[11]

[10] For example, PwC (2015) A Corporate Rate Reduction: the case for and against, 11 December.

[11] See Richardson D (2014) 'The taxation of capital in Australia: Should it be lower?' In Schroeder SK and Chester L (Eds) Challenging the orthodoxy: Reflections on Frank Stilwell's contribution to political economy, Springer, pp 181-202.

Having said all this, it is important to emphasise that lower corporate tax rates are not the only difference in the economic conditions before and after the 1980s. Until the late 1980s, companies faced much higher taxes on retained profits but, the introduction of dividend imputation in 1989 means that domestic companies pay a maximum of 49 per cent on their income. Dividends received by the domestic taxpayer have attached franking credits that, in effect, give the taxpayer a credit for company tax paid on their share of the company profit as represented by their dividend. However, before dividend imputation there was no integration between the two tax systems. For example in 1977-78 the company tax rate was 46 per cent and the top marginal tax rate was 65 cents in the dollar, the combined effect of which was a tax rate on the original company income of 81.1 per cent by the time it was received in the hands of the domestic investor the ultimate owner[12] - other years had even higher rates. Hence for ordinary Australian investors on the top marginal rates, income derived from the corporate sector was once taxed at more than 80 per cent. This is now a mere 49 per cent.

[12] After company tax, 54 cents in the dollar is left to distribute as dividends. That 54 cents is taxed at a maximum of 65 per cent, leaving 18.9 cents in the hands of the owner, implying that the total tax was 81.1 cents in the dollar.

Conclusions

This paper makes two contributions to the debate over the corporate tax rate: first, it presents data from a comparison of OECD nation to see if there is any difference in the performance of countries with different company tax rates. By comparing corporate tax rates across the OECD we have shown that there is no evidence to suggest that lower rates increase economic growth. Secondly, a historical analysis of Australia's own corporate tax rate shows that, if anything, lower rates have a negative impact on the kind of economic indicators spruiked by their proponents.

An examination of the OECD data demonstrates quite clearly that company tax rates do not have a negative impact on either economic growth or living standards. Company tax is, of course, only one of the many variables among these countries. It could be argued that we should do a multivariate study of some form in order to isolate company tax effects from other factors. But the need to do so would suggest that any effect of company tax cuts on economic growth and living standards is too small to have a discernible impact.

This paper also examined changes in company tax rates in Australia over the past 55 years/since 1960. These rates were compared with economic indicators including economic growth, growth in per capita incomes, and the GPD share of wages and private investment. Our analysis shows that the lowering of company tax rates in the late 1980s had no great impact on levels of investment. The small uptick in the period since the 30 per cent rate was introduced is more than accounted for by the impact of the mining boom and the privatisations, which transferred a good deal of investment from the public to the private sector. The lack of benefit of lowering company tax rates becomes much more apparent when economic growth and per capita growth are examined. Both performed much better under the high tax regimes of the early post-war decades than they did in more recent decades when taxes were lower. The wages share of GDP was also examined to test the view that the main beneficiary of company tax cuts is the work force, who, proponents argue, should experience an increase in wages. No support for that view is found in the historic record. Likewise, claims that company tax acts as a strong deterrent to foreign investment is not supported; foreign investment increased under the high tax rates through to 1988, and remained basically stable as company tax rates fell from 49 to 30 per cent.

We want to make it very clear that we are not arguing that higher tax rates increase economic growth/have a positive impact on the economy, only that there is no evidence to support the argument that they should be lowered. The BCA's CEO Jennifer Westacott titled her recent opinion piece on the subject, 'Start tax debate with right objective: Boosting growth'.[13] The evidence presented here suggests that if there are any growth dividends of lowering the company tax rate they are so weak as to be outweighed by other factors. Neither cross-country comparison nor Australia's own history lend any support to the 'tax-cuts-are-good' thesis. If the aim really is increased economic growth, then Australians would be better advised to ignore the business lobby's call for lower company tax rates and look seriously at other policies. Australia's golden age of economic growth, 1945 to the 1970s, was backed by full employment policies and investment in infrastructure, education, science and technology. It is this period that we should be examining and drawing lessons from. Instead we seem to be on a path towards acquiescence to the rent-seeking of business lobby.

[13] Westacott J (2015) 'Start tax debate with right objective: Boosting growth', The Australian Financial Review, 12 November