

The case against cutting the corporate tax rate

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Introduction

It is often argued that reductions in the corporate tax rate are necessary to create employment, increase investment and deliver a range of other benefits to the Australian community. However, despite the widespread support for this view, particularly among the business community, the theoretical and empirical case for such an expensive change in policy is weak.

This paper is structured as answers to a series of questions about the design and impact of the taxation of corporate income in Australia however it begins with a brief historical overview of the tax treatment of profits in Australia.

A brief history of corporate tax in Australia

From 1940 to 1987 the corporate tax rate was fairly stable in Australia, fluctuating within the range 45 to 49 per cent (although there was a lower rate 42.5 per cent applying to the first \$10,000 of profit in 1974). Since 2001 the corporate tax rate has been 30 per cent. According to many participants in the debate there should have been some benefits to the Australian economy as a result of the lower taxation. The most commonly cited benefits are higher job creation and investment.¹

There is, however, no clear evidence of such benefits. For example, since 2001 with a 30 per cent company tax rate the unemployment rate has averaged 5.2 per cent. Between 1950 and 1987 when the company tax rate was 45 to 49 per cent the average unemployment rate was 3.3 per cent.² In any case the promise of job creation on the part of business does not count for much when official policy seems to be to hold unemployment around 5 per cent. That is, given that monetary policy is used to stabilise the unemployment rate at around 5 per cent it is unclear how a lower corporate tax rate could lead to an increase in employment above the level of 'full employment' determined by the RBA.

Investment and other economic variables have hardly improved much either since Australia lowered its corporate tax rate to 30 per cent. Indeed, between 1960 and 1987 with high company taxes, investment in the private sector averaged 20.7 per cent of GDP while in the period since 2001 it was 22.1 per cent. The increase of one per cent of GDP in private investment is more than accounted for by the privatisations of public utilities and the mining boom.

Real economic growth averaged 3.8 per cent between 1960 and 1987 but fell to 3.1 per cent in the period since 2001.

If there is any truth in the proposition that lower company tax is good for the economy the effect has been too weak to make a noticeable difference in the macroeconomic data.

¹ Most of the rates reported in this paragraph come from the historic tables reported in Australian Taxation Office (2012) *Australian Taxation Statistics*. Where necessary those figures were supplemented by Australian Bureau of Statistics (various years) *Year book Australia*, Cat no 1301.0.

² Historic figures on the Australian economy are taken from the Reserve Bank of Australia historic tables at Reserve Bank of Australia. More recent figures are based on ABS (2012) *Australian System of National Accounts, 2011-12* and ABS (2012) *Labour Force, Australia*.

Is there strong theoretical evidence that cutting the corporate tax rate is good for the macro economy?

The obvious point to make about company tax is that it is levied on profits. Before being liable for any tax the company has to have covered all expenses including notional expenses such as the allowance for depreciation and amortisation as well as any capital write downs. No matter what the rate of company tax, it is only paid when the business has covered expenses. As Nobel Prize winning economist Joseph Stiglitz puts it 'if it were profitable to hire a worker or buy a new machine before the tax, it would still be profitable to do so after the tax...what is so striking about claims to the contrary is that they fly in the face of elementary economics: no investment, no job that was profitable before the tax increase, will be unprofitable afterward'.³

Stiglitz put the argument more formally in various academic papers but the point remains. Indeed, he says:

*From an efficiency point of view, the whole corporate profits tax structure is just like a lump sum tax on corporations.*⁴

A lump sum tax is typically considered by economists to be optimal from an efficiency perspective because it has to be paid no matter what and so should not affect how the individual will react to other incentives in the economic environment. While a tax on labour income may or may not change the individual's work effort, a tax that has to be paid no matter what will not change the incentive facing the individual.

In the case of a corporate entity, the essential argument is that investment will take place until the return on the marginal investment is just equal to the cost of capital and that will be true whether or not the company needs to borrow or can meet the investment cost out of retained earnings. Increases in the company tax rate will reduce the after tax return on the investment but will increase the value of interest deductions (or increase the tax on returns from keeping retained earnings in the bank). It is still profitable for the company to keep investing until that point. Hence Stiglitz says that the company tax 'is an infra-marginal tax on the return to capital (or pure profits) in the corporate sector'.⁵

The marginal condition (invest until returns just equal the cost of capital) is unaffected by the company tax rate. In principle that means the company tax rate can be increased substantially without altering corporate behaviour. Stiglitz criticises those who assert that the corporate tax rate introduces an inefficiency by increasing target rates of return on the part of investors. As he says 'they confuse the average with marginal cost of capital'.⁶

The review of the Australian Tax system by the then Secretary of Treasury, Ken Henry (the Henry review) saw the tax on economic rent as being a very good tax because it taxes the inherent profitability of a particular resource. However, the review seems unaware that the analogous argument applies to profit earned in the corporate sector. Just like a resource rent the company tax rate can be quite high without affecting the incentive to invest and, hence, without affecting behaviour.

³ Stiglitz JE (2012) *The price of inequality: How today's divided society endangers our future*.

⁴ Stiglitz JE (1973) 'Taxation, corporate financial policy, and the cost of capital', p. 33.

⁵ Stiglitz (1973), p. 26.

⁶ Stiglitz (1973), p. 33.

Is it true that that there is strong empirical evidence to support the claim that cutting the corporate tax rate has significant macroeconomic benefits?

The US Congressional Research Service has recently reviewed the empirical evidence that might or might not support claims to the effect that lower company tax rates increase economic growth, boost employment and the like.⁷ It generally debunks the notion that lower company taxes are beneficial in the ways usually suggested.

If the business interests and others who advocate cutting corporate tax rates were just motivated by the impact on employment and investment then as Stiglitz points out there are 'more precise ways to tweak the tax code than an across-the-board cut: [such as] lowering the tax on firms that created jobs and invested ...and raising taxes on those that didn't. Such a policy would raise revenues and provide incentives for more investment and job creation'.⁸

By contrast many other taxes are payable whether or not the company makes a profit. For example, the iron ore royalty rate in Western Australia will soon be 7.5 per cent of the value of the iron ore mined. If the mining company receives \$100 a tonne, pays \$7.50 in royalties and has expenses of \$95/tonne it will run at a loss. There is no way a profit related tax can make a profitable enterprise unprofitable.

Nevertheless there is a view that because foreign capital in particular is thought to be very mobile it would cause least distortion if it were taxed more lightly than other sources of income. Land and mineral resources are at the other extreme of mobility and a hence thought to be a very good tax base. This is a large topic that is taken up below.

However it is worth making the point that some of the recent discussion of company tax completely neglects the role of company tax in the overall progressivity of the tax system and the need for a company tax high enough to deter the use of the corporate form as a tax avoidance device by high income earners. Indeed, ever since the Barwick High Court it has been imperative that the company and top personal tax rates be aligned as closely as possible to counter tax avoidance.⁹

Does the US evidence that corporate tax cuts aren't that important hold in Australia, especially given that we have dividend imputation?

It is important that dividend imputation be incorporated into the analysis of company tax rates in Australia. Indeed, during a surge in company tax receipts the Budget Papers commented:

*Australia's imputation system may provide some incentive for companies to pay tax in Australia in order to maximise franking credits. In effect, the corporate tax system operates in part as a withholding system for tax due at the shareholder level. Indeed, in recent years the growth of franking credits claimed at the shareholder level has broadly matched the growth in company tax.*¹⁰

⁷ Gravelle JG and Hungerford TL (2011). *Corporate tax reform: Issues for Congress*.

⁸ Stiglitz (2012).

⁹ Prior to the Barwick Court the tax office could look behind artificial contrivances that were clearly designed for tax avoidance. The government has just released an exposure draft of legislation designed to counter tax avoidance. It remains to be seen how effective those initiatives may be.

¹⁰ Australian Government (2004) 'Revenue: Statement No 5', Budget Paper No 1, 2004-05.

More recently the view has been that Australia's company tax rate has been uncompetitive. For example, the recent business tax review published a graph that showed Australia's 30 per cent company tax rate was one of the highest among OECD countries. Of course those comparisons do not include the effects of imputation.

What is 'imputation'?

The design of Australia's company and personal taxation systems aims to prevent the so-called double taxation of dividends. The double taxation of dividends occurred before imputation as a result of the interaction of the company and the personal income tax systems. A company that earns a profit is liable to pay company tax. It may then pay a dividend to its shareholders who are also liable to pay tax. That meant that the final after-tax income of the shareholder might be a small proportion of the original profit.

The imputation system makes refunds to individual taxpayers to reflect the tax paid by the company and imputed to the individual. In practice every \$70 received as a dividend by an Australian income taxpayer is taken to be \$100 in working out the personal tax liability but \$30 is credited against the individual's tax liability. That may well entitle the taxpayer to a cash rebate. But it effectively means that the company income is ultimately taxed at just the individual taxpayer's marginal tax rate.

The amount credited against the individual's tax liability is referred to as a franking credit. Companies that pay tax maintain a franking credit account out of which they can declare a franked dividend, so long as the franking credit account maintains a positive balance.

In addition to individuals, trusts, partnerships and super funds are also eligible to claim franking credits. Companies too can earn imputation credits on any franked dividends they receive.

Note that franking credits are only available to offset against Australian tax liabilities.

Table 1 also provides recent figures for the company tax rate across a range of countries as well as what happens to a dollar of taxable corporate income by the time it is received in the hands of investors on the top marginal tax rate in that country. Where relevant, the company tax rate is that applying on company profits that is distributed to shareholders. The column headed 'Overall top personal income tax rate plus company tax rate' is the effective tax rate applying to company income by the time it is received in the hands of the individual shareholder. For many countries full or partial imputation applies and there are other mechanisms used to reduce the combined impact of company and personal tax. For example, many countries have preferential tax rates for dividend income.

Table 1: Company tax rates and impact on personal returns

Country	Company tax rate (%)	Overall top personal income tax rate plus company tax rate (%)
France	34.43	59.4
Denmark	25	56.5
United States	39.1	52.1
United Kingdom	24	51.4
Korea	24.2	51
Belgium	33.99	50.5
Spain	30	48.9
Portugal	31.5	48.6
Germany	30.175	48.6
Sweden	26.3	48.4
Ireland	12.5	48.4
Norway	28	48.2
Canada	26.1	47.9
Israel	25	47.5
Australia	30	46.5
Japan	39.54	45.6
Austria	25	43.8
Netherlands	25	43.8
Luxembourg	28.8	42.7
Italy	27.5	42
Finland	24.5	41.4
Chile	20	40
Greece	20	40
Switzerland	21.17	36.9
Iceland	20	36
Slovenia	20	36
Poland	19	34.4
Turkey	20	34
New Zealand	28	33
Hungary	19	32
Czech Republic	19	31.2
Mexico	30	30

Source: OECD spread sheet, overall statutory tax rate on dividend income

Table 1 clearly shows that it is misleading to compare just the company tax rate across countries. When ranked by company tax rates Australia is equal seventh out of 34 countries with a 30 per cent tax rate and there are 25 countries with lower rates. However, the data are entirely different if we examine the implied personal tax on company income, the overall top personal income tax rate plus company tax rate. On that basis Australia is ranked 15th highest with 19 countries below Australia. Of those 19 countries six are within 5 percentage points of Australia. Countries which are a major source of foreign investment in Australia, such as the UK and US, have much higher taxation on company profits by the time they are taxed in the hands of the taxpayer. The perception that Australia taxes company profits relatively highly disappears if imputation is taken into account.

Obviously other factors are important. The Swiss mining company Xstrata is a major investor in Australia but the Swiss overall tax on profits at 36.9 per cent is much lower than Australia's at 46.5 per cent. Similarly we have never had any trouble attracting investment from New Zealand even though their corporate tax rate is lower than Australia's.

As far as the individual (Australian) shareholder is concerned, holding a share in an Australian company and receiving the imputation credits is equivalent to the hypothetical situation in which the company pays no tax. In effect the present Australian company tax is effectively just a tax on undistributed profits, at least as far as Australian shareholders are concerned. In fact it acts like an undistributed profits tax that may well be refunded when and if the retained profits are returned to the shareholder.

The Australian company tax is also a tax on foreign shareholders since they do not enjoy the benefits of imputation.

The following provides a brief comparison of the role of imputation in company tax systems of OECD countries in 2000 with the system in 2012.

- Of the OECD countries that had a full imputation system, Finland, France, Germany, Italy and Norway either dropped it or implemented a partial imputation system.
- Italy, for example, has dropped the imputation system and replaced it with a 95 per cent exemption of distributed dividends from personal income tax.
- Spain and Turkey had partial imputation and abolished it.
- Canada went the other way, from a partial to a full imputation system.
- The countries that had full imputation in 2000 and still have it in 2012 are Australia, Chile, Mexico and New Zealand.
- The UK had partial imputation in 2000 still have it. Korea introduced it over that period.

If it is the personal tax rate, not the corporate tax rate that determines the tax paid by shareholders why to so many CEO's talk about the need to cut corporate tax rate so often?

It is not clear that managers are necessarily speaking on behalf of shareholders when they argue for lower taxes. This may well be a case of the principal-agent problem which refers to the possibility that the incentives facing the parties are misaligned as often occurs when there is a separation of ownership and control of the modern corporation. Hence the Australian shareholder receives imputation credits on any income received as dividends and so should not be concerned about the tax paid by companies—especially widely-owned companies.

However, the incentives facing CEOs are different to those facing shareholders. We are used to judging company performance by the size of after-tax profits and management incentive payment arrangements are likely to be related to after-tax profit. Perhaps more importantly, company management seems to be obsessed with growth in company assets—also likely to be a factor involved in determining management pay. The higher is company tax the less funds that are available to reinvest back into the business even though the company tax is returned to Australian shareholders through imputation. On the other hand a manager that can grow the company is likely to be rewarded with higher bonuses.

Despite the value of franking credits to shareholders, companies often have huge accumulated franking credits that are unused. At the end of 2009-10 franking credit balances were \$205 billion and they increased by \$8.1 billion that year. That year included the global financial crisis, however in 2008-09 companies accumulated an additional \$18.8 billion in their franking balances. From the shareholders' point of view that is a waste—idle franking credits do not earn interest and can only be used against dividend payments. We have recently seen BHP Billiton shareholders make that point. On the other hand management would prefer to retain profits in the company rather than give them out as dividends to shareholders.

Of course the incentive is different in private companies where there is a strong incentive for high income owners to keep funds within the company where they attract a lower tax than when distributed to the owner. In principle the funds are eventually passed on to the owners but while in the company they compound away at after-company-tax rates of return rather than lower after-tax returns in private hands.

The difference in incentives facing the company's owners and management can also explain a curious result in the literature. Takeovers among large conglomerates often do not realise the benefits management claim they will achieve in terms of economies of scope and scale that would ultimately benefit shareholders. However, CEO pay and company size are highly correlated so it makes sense for managers to convince shareholders that it is everyone's interest to grow by acquisition.

It is also worth pointing out that individuals and other entities eligible to claim imputation credits could suffer from a cut in company tax and therefore a cut in franking credits if their marginal tax rate is below the company tax rate. That would be the case unless the company increased its dividend payout rate to compensate. This case is illustrated with a worked numerical example in the appendix which examines the case of a super fund which is taxed at 15 per cent on earnings. A high income earner on 45 per cent marginal tax rate is also examined. The example compares the before and after impact of a change in the company tax rate from 30 to 25 per cent.

Of course some foreign shareholders unambiguously benefit from lower company taxes in Australia if they come from a tax jurisdiction with a lower tax rate than the Australian company tax rate and no obligation to pay the difference between the Australian corporate tax rate and their domestic tax rate, see the discussion on double tax agreements below.

Are CEOs pushing for lower corporate taxes being irrational?

CEOs who argue that the company tax rate should be lowered are not being irrational, indeed, as argued above, they have incentives to grow the company and it may be perfectly rational for them to want to reduce company tax rates and so increase the company's assets. The ultimate shareholder should be less concerned since a lower company tax rate implies franking credits are lower. As the example in the appendix shows, the shareholder may well be worse off unless the company increases the dividend payment sufficiently to compensate the shareholder for the lower franking credits.

Of course many CEOs also have a constellation of pro-business/anti-government attitudes which they seem to enjoy airing. In other contexts when business people put effort into policy arguments that would benefit themselves or their companies we refer to 'rent seeking'. Rent seeking is treated as a waste of resources that could be employed more beneficially elsewhere in the economy. The enormous effort that some business people put into arguing for business tax reductions seems to be a good example of rent seeking.

If corporate tax cuts are so important why couldn't business groups agree to fund such a reduction by reducing tax concessions? Isn't that the way they have been funded in the past?

Yes Keating's company tax cuts were financed by such measures as the introduction of capital gains tax and fringe benefits tax. However, the recent business tax review clearly revealed that the banks, for example, were happy to abolish the investment allowance which they hardly use, but capital intensive business such as mining who enjoy the benefits of these subsidies and objected vehemently to their removal.

It is important to note that in principle company tax concessions are worthless with imputation. A company that pays lower tax accumulates fewer franking credits and so there is less of the latter to give out to shareholders. However, in practice companies only pay out a fraction of their profits to their 'owners' and many tend to accumulate unwanted franking credits. But their retained earnings are likely to be higher as a result of the concessions.

Business and sometimes Treasury seem to want to use lower tax rates to attract foreign capital, but isn't foreign capital inflow driving up the dollar?

Foreign investment has been very high in the mining industry and Foreign Investment Review Board figures show that on the eve of the global financial crisis in 2008-09 it approved foreign mining projects worth \$91 billion up from just \$20 billion in 2005-06 and \$33 billion in 2004-05. Of course, FIRB figures only scratch the tip of the iceberg since they only measure direct investment and not the portfolio investment that has accompanied the boom. It is clearly the mining boom that has been responsible for a massive increase in foreign investment that in turn has contributed to the appreciation of the Australian dollar.

The high dollar has meant that investment has slumped in trade exposed areas apart from the mining industry which is driving the high dollar. Apart from those structural issues the high A\$ should not make a big difference. Take the case of an Australian government bond.

The face value of that bond as well as its interest payments are both expressed in A\$. An appreciation which is expected to persist into the future will not affect the rate of return on the bond. A Japanese pension fund attracted to the yield in Australia will invest in that bond unless there is reason to fear a devaluation of the A\$ in the near future.

We used to have a much healthier debate about the role of foreign investment in Australia. We are about to see massive investments in LNG for example that will be foreign owned and with minimal labour content. Most of the revenue will go abroad. Access to foreign capital is supposed to expand opportunities in Australia, however, foreign capital does not mean that it is easier to find skilled labour for construction, fast-track environmental approvals, put more traffic through the ports and the other problems miners apparently face.

That also alerts us to the likelihood that at the end of the boom foreign investment will dry up but high foreign ownership will mean that profits keep flowing abroad. The flow of profits out of Australia will offset the increase in mining exports that the current investment makes possible.

Why is it so easy to find the gross payments of company tax in the budget papers but not the figures that take account of franking credits?

Why the figures are ‘buried’ in the budget papers is not known. Franking credits would be included within the individual taxation figures—they would be netted out against taxation paid by individuals. That figure includes trusts and partnerships. There would be a similar treatment for superannuation funds. The Budget Papers have never given an estimate of the value of franking credits to our knowledge. However, Tax Office figures show that franking credits received by taxpayers are approximately 45 per cent of company tax collections. On that basis the net company tax in 2012-13 should be about \$39.1 billion rather than the \$71.2 billion reported in the MYEFO.

Incidentally franking credits are not included as tax concessions in the annual taxation expenditure statements. Rather, the imputation system is taken to be part of the benchmark arrangements for individual and company tax system and tax concessions are measured against those benchmarks. This is not an excuse for not reporting them in the budget papers. Note for example, that capital gain taxation is part of the benchmark but they are reported in the budget papers.

Who receives dividends in Australia?

This is an important question because one of the important rationales for company taxation is its role as a ‘backstop for the personal tax’. The idea is that by taxing corporate income high income earners at least pay something, even though avoidance and evasion often takes place via the corporate structure. This of course assumes high income earners are the main beneficiaries of corporate income. The later can be tested.

The latest tax office figures relate to 2009-10 and give total income as well as income received as dividends. Those figures are summarised in the following table.

Table 2 Taxpayers and dividend income

	Share of dividends (%)	Share of population (%)
non-taxable and below \$10,000	7.66	26.65
\$10,000 to 20,000	0.73	4.76
\$20,000 to 30,000	2.39	10.95
\$30,000 to 40,000	4.97	13.36
\$40,000 to 50,000	3.83	11.20
\$50,000 to 60,000	3.66	8.64
\$60,000 to 70,000	3.59	6.46
\$70,000 to 80,000	5.75	5.23
\$80,000 to 90,000	4.03	3.38
\$90,000 to 100,000	2.98	2.18
\$100,000 to 150,000	11.43	4.51
\$150,000 to 250,000	13.75	1.84
\$250,000 and above	35.24	0.82
Total	100.0	100
Memo item:		
Taxpayers \$1m plus	14.99	0.06

Source: Australian Taxation Office (2012) Australian Taxation Statistics, 2009-10.

Table 2 provides some interesting data but it does have some quirks such as the relatively high proportion of dividends received by those with a taxable income of less than \$10,000. However, our main interest here is the dividend incomes received by the highest income earners. Of those people who lodged a tax return there were less than one per cent who earned \$250,000 or more but they received 35.24 per cent of all the dividends. The next highest bracket, \$150,000 to \$250,000, is less than two per cent of the population and receives almost 14 per cent of the dividends. If we sum all those with income over \$100,000 we have 7.2 per cent of the population receiving 60.4 per cent of the dividends.

For those earning \$1 million or more it is interesting to note that they are just 0.06 per cent of taxpayers, 2160 people, who earned 14.99 per cent of dividends.

Not only is it true that the rich receive most of the dividends but it should be noted that 84 per cent of dividends are received by those on \$40,000 or above. Above \$37,000 the marginal tax rate exceeds the company tax rate. Tax avoidance considerations are relevant for all these people.

Is the company tax rate really a tax on wages?

A common view is that if company taxes are increased companies will respond and pass them on through higher prices and in turn reduce real wages below what they would have been. Hence company tax is at the expense of workers and evidence has been produced to that effect. The US Congressional Research Service heavily criticised those studies and showed their results were unrealistic. Nevertheless the Henry review quotes them or similar studies.

Treasury cites some of the overseas studies suggesting they are applicable to Australia. For example it cites three studies and the first finds 'that a 1 per cent increase in the corporate tax rate is associated with a close to one per cent drop in wage rates'.¹¹ This does not seem reasonable given the magnitudes involved. If the company tax rate were higher by 1 per cent in 2011-12 it would have increased collections by \$2.2 billion. Wages (compensation of employees in the national accounts) were \$708 billion and one per cent of that is \$7.1 billion.¹² This suggests that the impact on wages is over three times the impact on company tax.

The second study 'estimates that a 10 percentage point increase in the corporate tax rate reduces annual gross wages by 7 per cent'.¹³ That would increase company taxes by \$22.5 billion and reduce wages by \$49.6 billion.

The third study estimates 'that around 75 per cent of any increase in source-based taxes on corporate income is passed onto workers in lower wages in the long run'.¹⁴ That estimate is at least consistent with some company taxes being passed on eventually in real wage reductions. It is of course notoriously difficult to undertake econometric studies that successfully model the relevant structures of the economy and isolate the role of particular explanatory variables. Even if one could trust those studies they do not necessarily apply to the Australian tax structure. But we can have a look at Australian experience.

As mentioned above, from 1940 to 1987 the corporate tax rate was fairly stable within the range 45 to 49 per cent but since 2001 the rate has been 30 per cent. If the corporate tax is at the expense of labour then the reduction in corporate tax should have reduced pre-tax profit and so shifted the distribution of income away from profit towards wages and salaries. That is easy to check. On the Australian Bureau of Statistics figures from 1960 to 1987 the wages share (compensation of employees) of total factor income was 57 per cent when the corporate tax rate was at least 45 per cent. The average profit share (corporate profit plus mixed income earned by small business) was 43 per cent or 24 per cent after the notional 45 per cent corporate tax rate.¹⁵

Since 2001 the corporate tax rate has fallen to 30 per cent and so, if the thesis were correct, we might expect the wages share to increase to 66 per cent. That would preserve a 24 per cent going to after tax profit. But what happened? The wages share since 2001 has fallen to 54 per cent, contradicting the argument put by Treasury. Of course we would not want to put the opposite argument either.

¹¹ The Review Panel (2010). *Australia's future tax system: Report to the Treasurer, Part two, Detailed analysis*, Vol 1, p. 153.

¹² These and similar figures below are taken from ABS (2012) Australian System of National Accounts, 2011-12.

¹³ The Review Panel (2010). p. 153.

¹⁴ The Review Panel (2010). p. 153.

¹⁵ ABS (2012). Australian System of National Accounts, 2011-12.

In the meantime the spokespeople for business know the market and tell it how it is, for example, Australian Industry Group chief Heather Ridout¹⁶ and Australian Chamber of Commerce and Industry chief Peter Anderson¹⁷ in arguing for lower company taxation do not invoke public finance theorists to say that the tax cuts will be passed on to consumers or workers. Rather, in their more realistic understanding of the world, business will keep the tax cuts but, we are reassured, all will be fine because business will reinvest the money and thereby increase capital investment and employ more people.

What about International tax competition?

An important strain of the argument is concerned with Australia's attraction as an investment destination relative to the rest of the world. The idea is that the various countries are competing for investment and that the most competitive will win. This assumes that all potential investors collectively have limited investment budgets and will go to only the most profitable host nation.

The business view seems to reflect a 'pool of investable funds thesis': if you increase the pool of funds in the hands of business it will spend more and investment and job creation will follow. The thesis seems to be that there are limited funds available for investment and a lower company tax would mean more available for investment. Some big problems with this thesis are:

- Many companies pass on the bulk of their profits to their shareholders.
- At the moment many corporations are supposed to be flush with funds but investment has slowed outside the mining industry.
- Reluctance to lend on the part of financial institutions seems the main constraint on investment.

In practice we observe for example mining companies investing in projects in many countries at once, even though the fiscal and other attractions are vastly different. Mining companies with investment projects in Australia also have undertakings in Africa, the Gulf of Mexico, and so on. So long as a project meets the Stiglitz marginal condition a company that did not go ahead would be voluntarily ignoring a profit opportunity.

In practice we find a good deal of foreign investment in Australia from Asian countries with much lower company tax rates, in apparent contradiction of the argument that we would be 'losing out' to those economies. In 2011 China was the third highest foreign investor in Australia by value while India was fifth; Singapore was sixth, Thailand 12th, and Malaysia 14th.¹⁸ The simple point is that Australia attracts investments originating in the very economies that are supposed to have more competitive taxation systems.

Of course when examining the source of the stock of foreign investment in Australia by far the largest investors are the US at 27 per cent, UK at 23 per cent, Japan at 6 per cent, Singapore, Netherlands, Switzerland and Hong Kong at 2 per cent each.¹⁹

John Quiggin makes the point that attracting foreign investment to increase Australian GDP does not necessarily improve the lot of anyone in Australia.

¹⁶ Hepworth A and Uren D (2012). 'Cut company rate to aid workers, Henry urges'.

¹⁷ ABC (2012). 'Business slams scrapping of company tax cut'.

¹⁸ The figures refer to approved projects and come from Foreign Investment Review Board, *Annual Report, 2010-11*.

¹⁹ After that there are a large number with one per cent or less. See ABS (2012). *Balance of Payments and International Investment Position, Australia, June 2012*.

But let's take a stylised (though not totally unrealistic) example and see how it works out. Suppose a foreign company sets up a plant in Australia, bringing in \$1 billion of its own capital equipment. Suppose further that the business is sufficiently capital-intensive that the impact on employment can be disregarded, and that any input materials used would otherwise have been exported unprocessed.

Suppose that the business yields the standard return on capital obtained in the international market, say 8 per cent. Then it's easy to see that annual GDP has increased by 8 per cent of \$1 billion, or \$80 million. How about net national income? The \$80 million in capital income all flows overseas, so the impact on NNI [net national income] is a big round zero.

Which measure should matter to Australian policymakers? The answer – pretty clearly – is that the presence or absence of the plant makes no difference to the economic welfare of anyone in Australia, so NNI gives the right answer and GDP the wrong one.

Of course, the stylised example isn't perfectly accurate. Increased capital investment may lead to higher demand for labour and therefore to higher wages for Australians. But these indirect effects will be an order of magnitude smaller than the effects on GDP, and may be offset partially or completely (for example, if the increased demand is met by increasing immigration).²⁰

This argument is very important when we consider huge capital intensive projects with 100 per cent foreign ownership and very little in the way of local employment or other input purchases. These projects impose costs on the rest of Australia via Gregory effects but imply limited benefits for Australia.

In addition to all these problems with the international arguments it is also worth noting that the evidence does not stack up. Analysis by the Congressional Research Service showed there was no convincing empirical evidence that suggested international capital flows were influenced by corporate tax rates. The differences among OECD rates tend to be so small as to hardly matter compared with other factors.

Of course none of this addresses the international tax avoidance issue. A multinational operating in a number of countries will attempt to shift its profit to where it is taxed most lightly. When talking about tax avoidance the threat is not other OECD countries that may have rates plus or minus 5 points around the Australian rate. Instead the tax havens often have no tax at all. To the extent that international tax avoidance is rampant it tends to make a lot of the argument rather beside the point. International tax avoidance could be addressed by lowering tax rates but that seems to be throwing the baby out with the bathwater. In the meantime the OECD is trying to address international tax avoidance. And it may be worth considering other possibilities such as taxing income received by Australian entities in tax havens.²¹

²⁰ Quiggin J (2012). 'The problem with GDP.'

²¹ See Gravelle JG (2010). *Reform of US international taxation: Alternatives*.

Double taxation agreements and the taxation of company profits

Australia has double taxation agreements with 44 other countries with which Australia tends to have a good deal of economic contact. Those agreements require that where a country taxes a resident on income derived from the other country (the source country) it is required to give a credit against tax in the source country levied against the same income. Hence if profit of \$100 earned in Australia is taxed at \$30 in Australia and then received by a taxpayer in the US, that taxpayer will get credit for the tax paid in Australia. The US federal company tax rate is 35 per cent so US federal government would levy a tax of \$5 on the profit.

There is an important pragmatic argument for not reducing Australia's tax rate so long as it is at or around the rate of many of our foreign investment source countries. Australia has a double tax agreement with most countries in the world so that the same income is not taxed twice (see box). That is not raised in the report but it means that tax not collected in Australia often just goes to the foreign taxation authorities. This is best seen in an example. Take a US-owned company earning \$100 million in Australia which is subject to 30 per cent tax or \$30 million. That income is also taxed in the US at 35 cents in the dollar by the federal level. However, the double tax agreement means that the US company gets credit in the US for any tax paid in Australia. That credit is applied against any US tax that would otherwise be payable in respect of that income. So after the American company USXZ paid company tax of \$30 million in Australia its US (Federal) tax liability of the equivalent of \$35 million is reduced by \$30 million. If Australia now reduces its tax to 25 per cent USXZ will pay A\$25 million in Australia, which is credited against its US tax liability, but that means an extra A\$5 million will be payable in the US.

The US Treasury wins at the expense of the Australian tax system, just because Australia has lowered its tax rate. This example shows that where a country has a tax rate greater or equal to the Australian rate, a reduction in the Australian rate merely shifts revenue into the foreign treasury. For a company based in New York paying 40 per cent company tax, changes in the Australian rate will not affect their decision-making.

Appendix: Cutting the company tax rate from 30 to 25 per cent.

Impact on super funds and high income earners.

Take a company earning profit of \$100, paying tax on it, and paying a dividend of \$35.

Impact on super funds

Case 1: Dividend unchanged

	30% company tax	25% company tax
Company profit (=A)	100	100
Company tax (=B)	30	25
Dividend payable/super fund income (=C)	35	35
Imputation credit (C times 100 divided by (100 minus company tax)) (=D)	15	11.67
Tax on super fund (15% of C plus D) (=E)	7.50	7.00
Net income of super fund (including imputation credit = C+D-E)	42.50	39.67

The company could compensate the super fund by increasing the dividend payout from \$35 to \$37.5 as the example shows.

Case 2: Dividend increased to preserve after tax income of super fund

	30% company tax	25% company tax
Company profit (=A)	100	100
Company tax (=B)	30	25
Dividend payable/super fund income (=C)	35	35
Imputation credit (C times 100 divided by (100 minus company tax)) (=D)	15	11.67
Tax on super fund (15% of C plus D) (=E)	7.50	7.00
Net income of super fund (including imputation credit = C+D-E)	42.50	39.67

As suggested in the main paper, tax payers such as super funds on a low tax rate are hurt by a cut in the company tax rate unless the company compensates them through higher dividends.

The high income individual is worse off as Case 3 shows.

*High income individual taxed at 45 per cent (ignoring Medicare)***Case 3: Dividend unchanged**

	30% company tax	25% company tax
Company profit (=A)	100	100
Company tax (=B)	30	25
Dividend payable/personal income (=C)	35	35
Imputation credit (C times 100 divided by (100 minus company tax) (=D)	15	11.67
Tax at 45% (=E)	22.50	21.00
After tax income (C+D-E)	27.50	25.67

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