Robert Oser BEc LLB FCPA

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The Commissioners
Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Dear Commissioners

Creating a more dynamic and resilient economy

This is a submission confined to the draft recommendations for corporate tax reform to spur business investment.

Draft Recommendation 1.1
Pivot the corporate tax system to a more efficient mix of taxes.

Corporate behaviour is unlikely to be more than marginally sensitive to recommended changes of Australian taxes including corporate tax. This view is different to that found in the modelling and related predictions of the Productivity Commission (PC).

Overall, lowering the total **"cost of doing business"** in Australia is the key to make business investment more attractive, and see further comments below.

The Executive Summary of the PC report concedes that: *the ever-growing burden of regulation puts a significant brake on productivity growth that is more difficult to address.*

This costly burden negatively impacts *the investment incentives faced by firms* and works to reduce proposed benefits to attract new investment from corporate tax reform.

An alternative approach to boost productive economic activity and new investment would be to expand tax concessions for targeted activities.

- Broadening the immediate write-off for new productive equipment. The benefits of the cashflow tax in the expensing of capital expenditures can be replicated to the extent appropriate in the existing system.

- Introduction of tax-free or low-tax geographic zones for manufacture, especially defense equipment, including the AUKUS submarine commitment. A less than 20% corporate tax rate (with a sunset clause) and minimal tariff/excise imposts plus personal income tax benefits to attract skilled labour, would have a strong incentive effect with some "trickle down" benefits. Such incentives can be expected to be more effective than a cashflow tax but may lead to reduced tax collections.

- The proposal for a "patent box" regime should be revived and expanded beyond its original intended scope of medical and biotechnology innovations.

- The existence of Federal and State Government subsidies and cash grants for selected projects such as renewable energy, advanced manufacturing, infrastructure and many others, need to be reviewed to determine whether additional benefits are warranted, if the PC recommendations are implemented.

The PC puts overwhelming weight on the endeavour to increase "capital expenditure" from declining levels to boost a more dynamic and resilient economy. Capital expenditure is defined as "*non-labour production inputs*".

The "knowledge economy" does not require physical assets such as *factories, machinery and equipment*.

The recommendations would be strengthened if the expressions "capital expenditure" and "deepening capital" can be given a precise meaning in the context of the discussion.

Draft recommendation 1.2
Lower the company tax rate to 20% (for companies with revenues less the $1 billion)

If international tax competitiveness is real rather than theorised, there is justification for the reduction of the statutory rate 30% rate.

The PC expectation is that the reduction of the current statutory company tax rate of 30% will:
- increase corporate business investment; and
- attract foreign capital into Australia, presumably at a greater rate than under the existing regime.

That expectation can be challenged. Causal relationships are difficult to establish and taxpayer behaviour in response to tax changes can be unpredictable, notwithstanding extensive academic studies to the contrary.

An OECD brief has stated:
... while tax is recognised as being an important factor in decisions on where to invest, it is not the main determinant. Investment is attracted to countries offering access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure. (OECD Policy Framework for Investment)

According to Ross Garnaut and others (see further below):
The empirical evidence on the effect of corporate income tax rates on investment decisions is not compelling. The case is often argued from a model that assumes unrealistically that there is perfect competition in all irrelevant markets. Even in competitive situations, other considerations are highly influential on investment decisions, including the tax base, sovereign risk, the independence and transparency of regulatory and legal systems, foreign exchange restrictions, workforce skills, and geographic location.

US academics, Avinash Dixit and Robert Pindyck have argued that:
Uncertainty about policy and the economic future is the real key to investment rather than the level of interest rates, taxes or investment subsidies.
(*Investment Under Uncertainty*, Princeton University Press 1994).

According to the OECD (2024) average corporate tax rates were:

OECD average [1]	23.85%
EU Member average	21.27%
G7 average	27.15%
Worldwide average	23.51%
GDP Weighted worldwide average	25.67%
United States (combined Federal + State)	25.77%

These rates are not helpful to the advocacy for reducing the 30% rate.

Countries neighboring Australia with low tax rates, often cited to contrast with the 30% rate, have lesser outlays on social welfare expenditures than Australia as a proportion of GDP. Therefore, these countries have less need for high tax collections and have comparatively low tax rates for personal and company tax.

In other cases, mainly in the EU, high rates of VAT allow lower rates of company tax. For example, Ireland has a standard VAT rate of 23% and a corporation tax rate of 12.5% on trading income.

There are three important issues to consider in conjunction with the reduction of the company tax rate to 20%:

1. Under Australia's full imputation system of integrating corporates and shareholders, a reduction of company tax payments will cause a corresponding increase in tax liabilities of shareholders such as individuals and superannuation/retirement funds who rely on franking credits (which are reduced);

2. Foreign owned multinational companies will benefit from the tax-cut; and

3. If the headline company tax rate is reduced to less than 25%/30%, the value of existing incentives will be reduced, making the reduction partially counterproductive. The tax incentives potentially adversely affected include R&D.

I am not competent to comment on the modelling by the PC which shows a compelling case for the draft recommendations. I note that the validity of economic modelling requires review of the assumptions in the model [2].

The PC report states that: *Declining business investment makes us less productive*. This situation must be understood in the context that Australia is a mature economy with new market opportunities limited by comparison with the USA, the EU, India and China. The PC describes Australia as a *small open economy*, to which can be added, with impediments such as barriers to entry and regulatory excesses.

Foreign investment is likely to be directed at take-overs of Australian assets and businesses, especially in agriculture, energy and infrastructure rather than in new productive investment.

Of course, these facts should not prevent measures which are designed to improve productivity and improvements to the tax system for corporate entities.

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[1] The PC's claim of OECD average of 21% seems incorrect (PC page 12).

[2] In Box 1.6 an investment of $100,000 shows a pay-back in~3.5 years. This is unreasonably optimistic for a new investment in the Australian economy.

A potentially fundamental flaw in all studies and models showing an increase in business investment, if taxes are reduced, is that the intended benefit will not follow if the business cannot forecast with reasonable certainty that profits will be made to cover the marginal cost of the capital invested.

Simply put, businesses do not invest just because there is cash available from a tax cut.[3]

Draft recommendation 1.3
Introduce a net cashflow tax of 5% (on all companies)

According to Ross Garnaut and Others [4] the cashflow tax is designed to replace a classic company tax regime. This is consistent with comparable studies recommending such a reform. This work followed the Henry Report in Australia [5].

The earliest idea of a cashflow tax by E Cary Brown in 1948 [6] to better create tax neutrality has been followed by many academic studies dealing with variations as to the tax base [7] and accommodation for the finance/bank industry but practical applications have not followed (with the exception of Estonia and Latvia?). The Brown model is "two-sided" in that it compensates for negative cashflows.

Briefly, the cashflow tax is simple in concept. The R-based version taxes cash receipts from the sale of goods and services and allows 100% deductions for capital expenditure. Financial items such as interest and dividends are disregarded. These features are designed to be tax neutral when compared with existing systems on the ground that it does not distort decisions about capital expenditure and financing.

The concept has a radical feature. The pure form of the cashflow tax is imposed on "economic rents" (assuming there are any). Normal return to capital is not taxed at all, assuming the cash flow tax replaces the classic company tax regime, as in Australia. This is best explained in the Henry Report in Box D1-1.

The OECD reviews three different cashflow tax bases (R-base, R+F-base and S-base) [8].
The Garnaut study [9] is most relevant to Australia and the best argued in the extensive international literature.

In Garnaut:
The cash flow tax would have as its base net cash flows, being taxable revenues (excluding any interest income) less non-financing cash outlays (operating costs plus capital expenditure, but with no allowance for interest or other financing costs). The accounting data for revenues and expenditures would be exactly the same as for corporate income tax and the PRRT, so that established case law would apply. No distinction is drawn between capital and recurrent expenditure.

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[3] Tibor Hannapi et al: (2023) OECD Economics Department Working Papers No 1765 *How does corporate taxation affect business investment?*
[4] Ross Garnaut and Others: *Replacing Corporate Income Tax with a Cash Flow Tax*, The Australian Economic Review vol 53 (2020) no 4.
[5] Report to the Treasurer: *Australia's Future Tax System* December 2009 Part Two D1.
[6] EC Brown:(1948*) Income Employment and Public Policy: Essays in Honor of Alvin H Hansen*
[7] JE Meade (1978): *The Structure and Reform of Direct Taxation* Report for the IFS and
Mervyn A. King (1987*): The Cash Flow Corporate Income Tax* in Martin Feldstein (Ed.), *The Effects of Taxation on Capital Accumulation (pp. 377–400). University of Chicago Press for the National Bureau of Economic Research*
[8] *Fundamental Reform of Corporate Tax*, (OECD Policy Studies No 16 (2007)
[9] ibid

In years when negative net cash flows are recorded, we propose that an amount equal to the negative net cash flow multiplied by the tax rate be certified by the ATO and rebated to the taxpayer.

None of the literature discusses the appropriate rate of cashflow tax and each proponent claims simplicity without a clear path for practical adoption, especially with the need for transitional provisions, bearing in mind that the tax is intended to replace in its entirety, the traditional corporate tax regime [10]. While the academic studies are favourable to the net benefits offering from the cashflow tax, the views are not unanimous [11].

The PC report acknowledges that further work is required for phasing-in and the finance/banking sector.

I submit the following comments on the cashflow tax:

- The proposal of the 5% cashflow tax is a "toe in the water" approach which is unlikely to show immediate identifiable benefits in generating new capital investments. It is a precursor for leaving the existing company tax system to tax "economic rents".

- As a value judgement, I believe it is counter-productive in Australia to tax "economic rents" at higher than the 30%/25%/20% standard rates of company tax. The isolation and taxing of economic rents is claimed to be one of the important features of the cashflow system. Australia is said to be currently in economic stagnation. Adding a 5% cash flow tax on top of the 20% or 30% rates is detrimental timing.

- Whatever the merits of a new and radical change to taxing companies, the existing economic and regulatory environment is unlikely to cope with a novel compliance burden without creating a new, added "deadweight cost" of taxation.

- I suggest that the PC and Treasury develop the preferred cashflow tax design for Australian conditions. Such work should add "road-tests" applied to selected large ASX companies in addition to theoretical modelling so that the practical results can be evaluated.

- In the two-sided cashflow tax model, the time value of losses (negative cashflow) should be reimbursed to the company. Most new ventures, especially large industrial projects, have initial tax losses before turning profitable. The compensation for negative cashflow may have material implications for Federal Budget management.

- It is not clear whether tax avoidance such as transfer pricing is made more difficult or easier in the cashflow system [12].

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[10] Jack M Mintz and Jesus Seade: *Cash Flow or Income? The Choice Base for Company Taxation* The World Bank Research Observer (1991) Vol 6 No2

[11] Lily L Batchelder: *The Shaky Case for a Business Cash-Flow Tax Over a Business Income Tax* National Tax Journal, (2017) vol 70 No 4, pp901-936,

[12] According to AJ Auerbach the standard (origin-based) cashflow tax can encourage profit shifting to low-tax countries. Therefore, a destination-based cash flow tax is preferred, with unresolved complexities. AJ Auerbach (2017): *Demystifying the Destination-Based Cash-Flow Tax* NBER Working Paper no 23881.

- It is unclear whether the cashflow tax paid will qualify as a franking credit attached to dividends. Additionally, there is no PC commentary whether a full imputation system is compatible with long term corporate tax reform with or without a cashflow tax.

Summary and conclusion

On balance, the 30% statutory tax rate should be retained for companies other than those subject to the 25% rate. Options to achieve new business investment by targeted incentives should be implemented in conjunction with the retention of the 30% rate. This is an improvement on the unintended encouragement of arbitrary and non-productive investment. This approach can be harmonised with the extensive existing Government cash grants and subsidies for activities which are favoured for competitive survival.

Subsidised industries should not benefit from "double-dipping" tax concessions.

By creating a new class of taxpayers, it is intended to penalise growth in gross revenues above $999,999 by denying the reduction of the tax rate to 20%. This idea is in clear conflict with arguments recommending Draft recommendation 1.2.
The $ amount is arbitrary, unindexed and a disincentive for the growth of company groups from successful capital investment advocated in this PC report.

The 5% cashflow tax is an innovative first step in the reform of the company tax system and should be introduced with adequate resources allocated to monitor its effect on company behaviour but only after unresolved issues are addressed (transition, finance industry and international transactions).

The cashflow tax should not be applied to small business companies on the assumption this segment of the economy is unlikely to generate economic rents and is already under the burden of regulatory compliance [13].

Whenever a new tax is introduced, the expectation of taxpayers is that the tax will be broadened, and the introductory rate increased. For this reason, the 5% rate should be locked in by tight legislation for a specified number of years.

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Please let me know if you have any questions. I will try to answer them.

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Robert Oser

[13] On page 2 (Draft recommendations) it is written the new net cash flow tax is expected to create an increased tax burden for companies earning over $1 billion. On page 7, (1. Corporate tax reform to spur business investment, Summary) it is written "introduce a net cashflow tax of 5% for **all** companies).