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Lower Company Tax to Resuscitate the Economy

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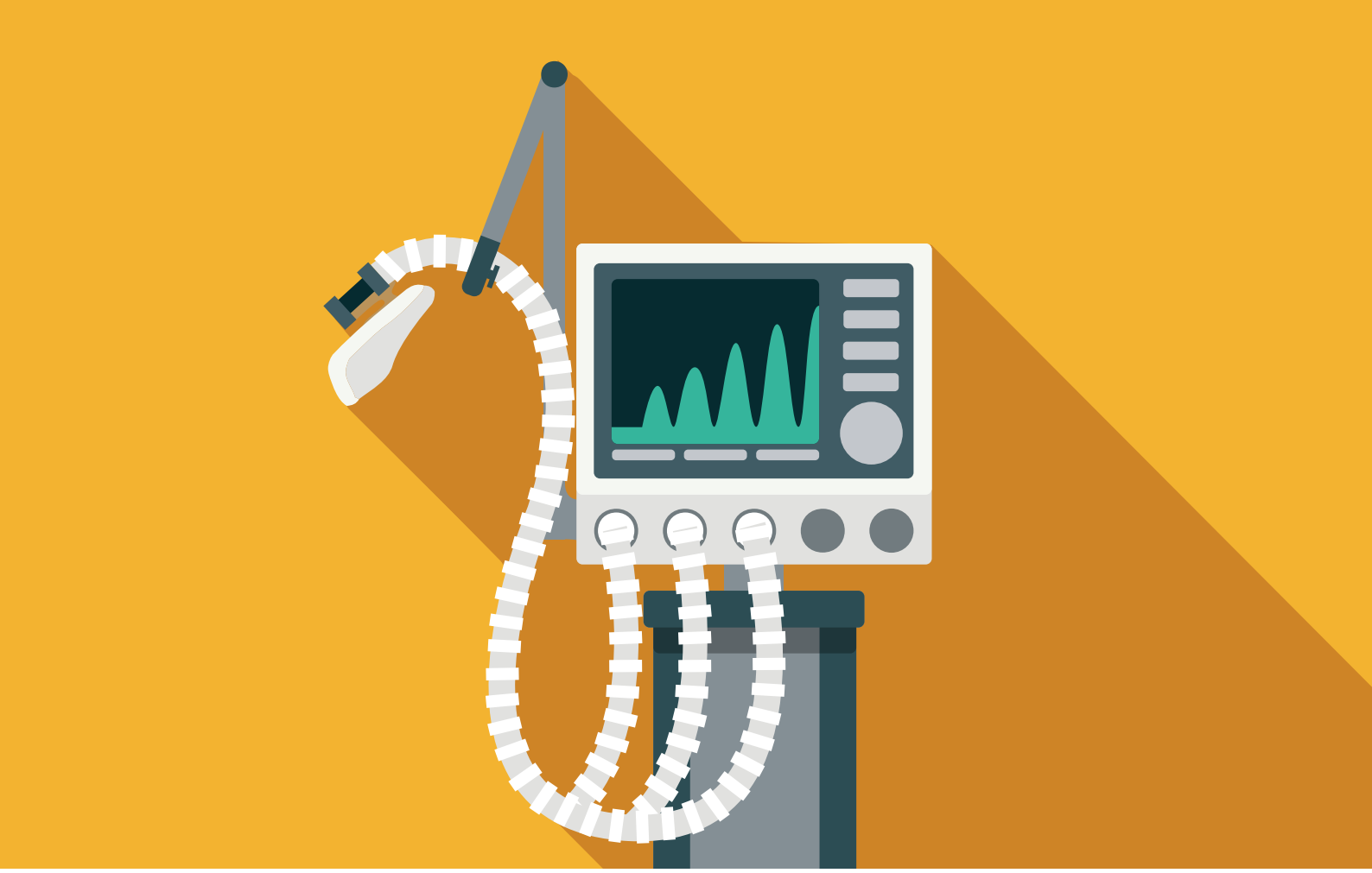


1. Background and current context

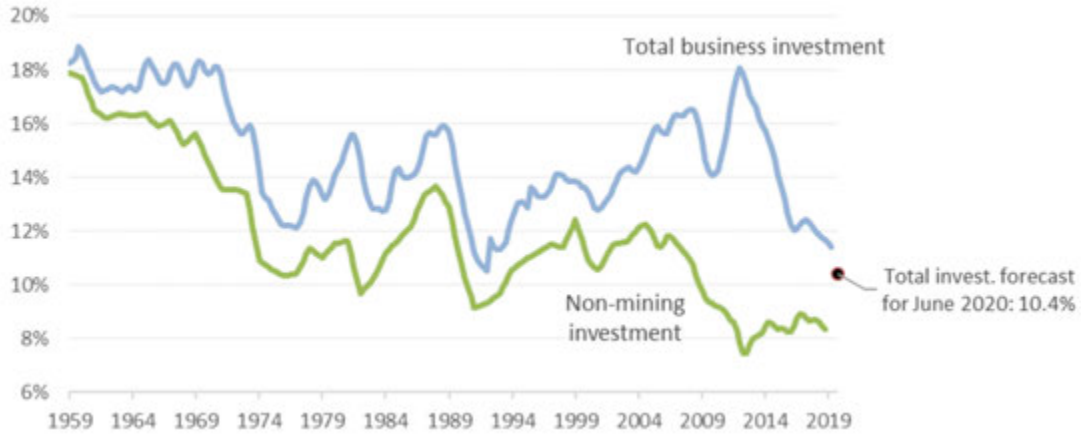
Macroeconomic shocks are usually analysed as either aggregate demand shocks (financial crises, investment slumps, export booms) or aggregate supply shocks (oil price fluctuations, productivity changes, wage hikes).

However, the COVID-19 shock has simultaneously been both an aggregate supply and aggregate demand shock; caused by deliberate government action. Aggregate supply contracted massively, first due to supply chain disruption, then forced business closure — while aggregate demand collapsed due to employment-related income loss, restrictions limiting household consumption, and great uncertainty about the near future. These shocks have sharply reduced GDP and increased unemployment; with the IMF forecasting the Australian economy to contract around 7 per cent this year.[1] Since March, the official unemployment rate has passed 7 per cent with close to 230,000 jobs lost. The so called 'underutilisation rate' — which combines the unemployment and underemployment rates — is close to 20 per cent and likely to rise further this year.[2]

Even before the impact of COVID-19, Australia's recent economic performance had been weak. GDP rose by only 2.2 per cent in the year to December 2019 compared to an average of nearly 3.5 per cent over the previous 50 years[3] and on an income per head basis Australia has been in recession. Over calendar 2019, seasonally adjusted wages rose by 2.1 per cent compared to the average annual growth rate for the previous two decades of over 3 per cent.[4] The sluggish wage growth rate has mainly reflected anaemic private investment that, in turn, results in weak productivity growth. Australia's labour productivity growth rate was around 0.2 per cent in 2019, compared to an average of around 1 per cent over the previous 40 years.[5] Figure 1 shows that private investment as a share of GDP, especially non-mining investment, fell steeply during the mining boom and has remained very weak since.

Put simply, the already feeble economy now faces a perilous post COVID-19 future. Without the development of a successful vaccine, the productive capacity of the economy could be hit again by lockdown restrictions and/or possible ill health of a portion of the labour force. Deloitte Access Economics forecasts that already anaemic business investment will decline by close to $70 billion in 2020,[6] while federal Treasury forecasts a June quarter investment decline of 18 per cent.[7] This would take total business investment down to close to 10 per cent of GDP, the lowest level on record (see dot on Figure 1).

Figure 1: Business Investment as % of GDP



Source: ABS National Accounts, Table 24 from 2000 onwards and ABS Australian System of National Accounts, table 52 before 2000. Figures are smoothed.

In response to the economic contraction, the federal and state governments have dramatically expanded the scope and scale of state involvement in the economy. Payments to the unemployed have been doubled (JobSeeker). A lump-sum cash payment has been made to anyone receiving a welfare payment. Employers have been funded to keep under-employed workers in their jobs (JobKeeper), health expenditure has been boosted and pre-school made free. This massive spike in government spending continues to be funded by increased government borrowing that has put Australia on a path to having about a trillion dollars' worth of public debt,[8] mostly owed to foreigners.[9]

Some of the policies implemented can be considered as welfare payments aimed at ensuring that people whose livelihoods have been impacted by the COVID-19 restrictions are able to maintain themselves and their families. In this way, they are part of the social safety net, as well as a means of temporarily holding together the core structure of the economy.

However, the welfare support measures should not be regarded as policies that will ensure a recovery from the current downturn. Wealth is not generated from government-funded consumers' spending.[10] Rather, it comes from profit motivated production in the private sector. Ongoing policy initiatives focused on governments borrowing in order to stimulate the economy — particularly through consumer spending — will fail to revitalise the long term productive capacity of the economy.

This is particularly true when government spending pursues politically-motivated schemes and subsidies that fail the benefit-cost test. Good examples include spending on infrastructure such as the very fast train link between Sydney, Canberra and Melbourne, and renewable energy schemes as part of the much touted but economically flawed 'green economy'.

In contrast, there is general agreement in mainstream macroeconomics that private investment not only boosts aggregate demand in the short run, but strengthens economic growth on the supply side in the long run via an enlarged capital stock. Hence, the recovery of the economy to sound economic health depends on resuscitating the productive capacity of the business sector through increased private investment that will feed through to higher labour productivity and wages. The best way to achieve higher private investment is to reduce the tax burden the federal government places on Australia's companies.

2. Companies and economic well being

At the heart of Australia's economy is the limited liability company. Australian companies are legal entities that allow people to invest their savings into productive ventures in return for ownership as shareholders. The share owner's liability for any losses their company makes is, by law, limited to the amount of funds they have in their shareholding. This limitation to owners' liability is important because it gives confidence for companies to take the risks required to invest, employ workers and produce the goods and services people want.

To achieve these outcomes, investment funds have to be available to Australian companies. As private investment as a share of GDP has fallen (Figure 1), so too has the capacity of Australian companies to generate economic wellbeing. To understand the decline in private business investment, the source of those funds has to be considered.

For much of its economic history, Australia's private investment in aggregate has been greater than the amount Australia has saved, which has manifested as a current account deficit in the balance of payments accounts. This external deficit, matched by inflows of foreign investment, has been a testimony to Australia's international appeal as an investment destination. However, in recent years the investment-saving gap as a proportion of GDP has narrowed sharply, as Figure 2 shows.

In this figure, the vertical distance between the investment line and saving line measures the current account deficit, which has now disappeared due to a slight recent rise in saving accompanied by the larger fall in investment (also shown in Figure 2). While the quarterly current account surplus has been trumpeted as an economic success in the media and official circles, to the extent that it reflects falling private investment, it is a worrying development. Australia has now experienced four consecutive quarters of current account surplus (CAS) from the June quarter 2019 to the March quarter 2020.[11]

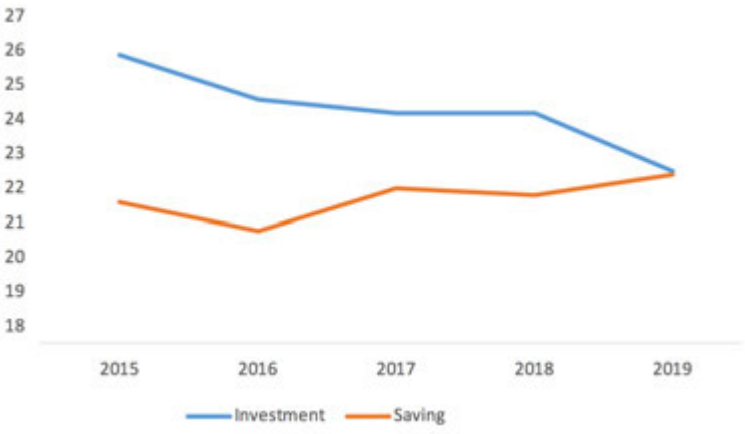
Historically, by freeing the nation from the constraint of its saving level, foreign investment has served Australia well by raising national income, through a larger capital stock, higher productivity, more employment opportunities and higher wages.[12] As a general principle, the greater the international investment, the greater the economic welfare gains.

At the microeconomic level, foreign investment should be welcome because it delivers productivity gains via technology transfer, international management practices and product development — and can spur greater domestic competition and imitative behaviour by existing locally-owned firms.

Company tax is an important limitation to the ability of companies to respond to the profit motive by investing in capital and hence providing higher output, jobs and wages. In Australia, of every dollar of profit earned by a company, 30 cents[13] is paid in tax. With less profit remaining after tax, companies therefore have less incentive to invest here and increase Australia's productive potential, income, wages and wealth.[14] International capital is mobile, and responds to after-tax returns. Hence, foreign investment and current account imbalances are strongly influenced by relative differences in after-tax rates of return on capital across borders.[15] With higher company tax rates, an incentive arises to shift operations abroad; which also implies lower domestic employment and wages.

A clear strategy to stimulate the level of business investment in Australia in a post-COVID19 setting is therefore to reduce the burden placed on companies by lowering the company tax rate. Evidence of the benefits that would flow from such a strategy are outlined next.

Figure 2: Australia's Investment-Saving Gap



Source: International Monetary Fund (2020) Australia 2019 Article IV Consultation, IMF Country Report No 20/68, IMF, Washington DC, Table 1.

3. The benefits of a lower rate of company taxation: Some evidence

There is substantial international evidence as to the impacts of a reduction in company tax: output increases; more workers are employed; productivity is enhanced; and the nation's ability to compete for investment funds is improved. A sample of this evidence is presented in this section.

3.1 Increased production

A lower tax rate on profit provides a stronger incentive for companies to increase investment and output. Across the whole economy, this means a higher level of GDP.

In Canada,[16] a 1 per cent reduction in the tax rate was found to increase real per capita GDP by 1.2 per cent in the long run; while for the US[17] the increase was estimated to be 0.6 percent after one year. A study involving 70 countries[18] found that cutting the corporate tax rate by 10 per cent increased annual growth in GDP by up to 2 per cent. The OECD (2012)[19] concluded that company tax has "sizable adverse effects on labour use, productivity and capital accumulation [i.e. investment]" (p198). This is consistent with earlier OECD (2010) research[20] that found "corporate taxes are the most harmful type of tax for economic growth" (p10). The OECD and IMF country reports for Australia have repeatedly recommended lowering company tax rates.[21]

Higher company taxes also reduce the incentive to innovate, and discourage risk-taking; with consequential negative effects on output over time. In the US,[22] higher company taxes are associated with lower quality, and quantity of, innovation. Another study found 'star' scientists were discouraged from moving to US states with high company tax rates.[23] A study of the impact of corporate income tax on mid-sized companies in 85 countries found a large adverse effect on business investment, foreign direct investment, and entrepreneurial activity arising from corporate taxes.[24]

3.2 Increased employment

With businesses increasing production in response to a cut in company tax, more inputs to the production process will be purchased. That would include employing more people. A number of studies have examined the effects of reduced company tax on employment.

Across US states, a lower corporate tax burden of one percent has been found to increase employment by about 0.2 percent.[25] The US experience is replicated in Europe, where a one dollar (equivalent) increase in the corporate tax burden was estimated to decrease a businesses' total wages bill by 49 cents in the long run.[26] While a lower wage bill can come from a decline in wages or employment — or some combination of both — the evidence of a negative impact on workers is clear. The implication of this evidence is that even a cut in Australia's company tax rate from 30% to 25% for all companies would increase employment by between 3.3% and 6.6%.

3.3 Increased productivity and wages

With greater after-tax profit, the incentive to invest in production will be higher. Investment in capital equipment will increase labour productivity, making it feasible to employ more people and pay higher wages.

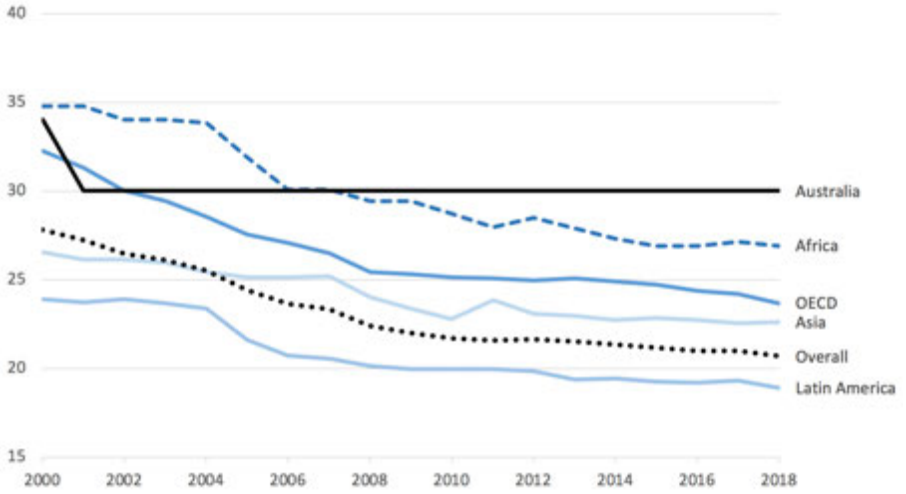
Across US states,[27] a 1 percent increase in the top corporate tax rate was estimated to reduce the total wages bill by between 0.14 and 0.36 percent; and for US multinational firms operating in 50 countries from 1989–2004, the burden of company tax on workers varied from 45% and 75% of the total.[28] Another study[29] found a 1 per cent cut in business taxes in US states increased real wages by 1.1 per cent over a 10-year period.

In Germany,[30] a study reported the benefits of productivity induced wage increases resulting from company tax cuts favoured lower paid workers. Another study in Germany[31] showed that company taxes had a larger adverse effect on the wages of low- and medium-skilled workers, women, and younger workers. This is consistent with an OECD study that found company tax cuts significantly boosted the income of the poor in OECD countries.[32]

3.4 Increased international competitiveness

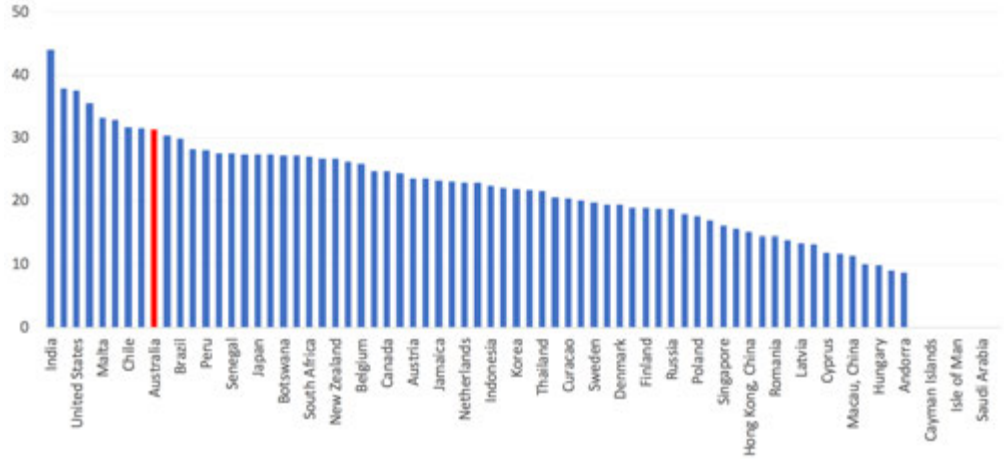
An obvious reason why private investment in Australia is worryingly low is because in a world where the competition for capital remains intense, Australia's company tax rate of 30 cents (and 27.5 cents for smaller companies) for every dollar of profit is among the highest in the world; exceeding the average rates for all international regions (see Figure 3).[33] In 2020, the global average and OECD country average company tax rates are around 23 per cent, with the EU and Asian country average rates being in the order of 21 per cent.[34] The United States and the United Kingdom — traditionally Australia's two main sources of foreign direct investment — have rates of 21 per cent[35] and 19 per cent respectively.[36] The company tax rate in Hong Kong and Singapore (the world's most competitive country according to the World Economic Forum's competitiveness measure) is 16.5 per cent, 12.5 per cent in Ireland, and 14.84 per cent

Figure 3: Corporate income tax rates for Australia and selected country groupings



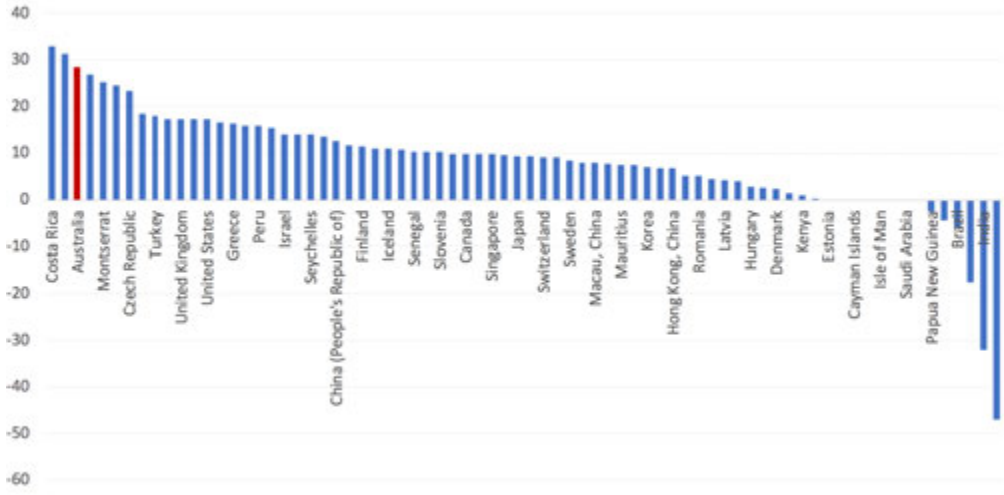
Source: OECD Corporate Income Tax Database. Averages are unweighted and do not include tax reductions since 2018.

Figure 4: Effective Average Tax Rates, 2017



Source: OECD Corporate Tax database; note the US figure is prior to the US corporate tax cuts.

Figure 5: Effective Marginal Tax Rates, 2017



Source: OECD Corporate Tax database; note the US figure is prior to the US corporate tax cuts.

in Switzerland. According to this competitiveness measure, Australia only ranks 16th in the world.[37] In its 2020 Country Profile of Australia,[38] the IMD ranks our overall tax competitiveness at 26th in the world, down from 23rd in the previous year. On corporate tax specifically, Australia ranked 52nd and only 1.1 per cent of CEOs surveyed thought Australia's tax regime was attractive.

Importantly, 'statutory' rates of company tax do not always represent the 'effective marginal tax rate' that incorporates specifics of individual countries' tax policies, such as investment allowances.[39] Based on an OECD analysis for 2017, while the statutory company tax rate in Canada is 26.5 per cent, the effective marginal rate is 9.8 per cent. In NZ the statutory rate is 28 per cent but the effective marginal rate is 15.5 per cent. In contrast, Australia's effective marginal rate at 28.5 per cent is only marginally lower than its statutory rate.

The effective marginal tax rate for Australian companies was third highest in 2017 out of 74 countries, while our effective average tax rate is ninth highest (see Figure 4 and 5).[40]

Australia has (before tax) comparative advantages in the production of a range of goods and services but it has no monopolies of supply into world markets. Australia has always depended on foreign investment for its economic development. However, it now faces a situation of current account surplus. Australia competes with other locations as an investment site for mobile international capital, with many alternative investment locations. With Australia's current company tax rate being well out of line with its international competitors, the incentive is for companies to look elsewhere for profit-maximising production investment locations, and for companies currently located in Australia to consider relocating offshore. Lowering the company tax rate is therefore more about removing barriers to multinationals retaining and building their investments in Australia and is certainly not providing 'aid' to these businesses. Given its location in the most dynamic region in the world, Australia has the opportunity to significantly increase its private business investment levels through a reduction in the company tax rate to a level that is consistent with its international competitors (notably in the Asian region). This would provide a boost to employment, wages, economic growth, household incomes and innovation, as detailed in the evidence above.

4. Discussion

4.1 Dividend imputation

When an Australian company pays a dividend from profits, and the company has paid tax on the profits, the dividend would usually have a franking (or imputation) credit attached. Australian taxpayers can use franking credits to offset the tax they would otherwise pay on the dividend. The policy is designed to avoid the double taxation of dividend income. The implication is that a taxpayer paying (for example) a marginal tax rate of 50 cents in the dollar may only pay an additional 20 cents in a dollar of tax on dividend income, if the company paying the dividend has paid tax of 30 cents in the dollar.

In theory, an Australian shareholder might be unaffected by the rate of company tax as any change is simply offset by the associated change in franking credits made available. However, this conclusion does not accord with reality. Most companies retain some profits, and do not pay out all profits each year, meaning some franking credits are unused for many years, and value of the credits in today's money is devalued. Various studies show that companies do not act as though franking credits fully offset the impact of company tax.[41] In detailed review of the evidence,[42] the Australian Energy Regulator found that the financial market discounts franking credits in energy businesses by 41.5 per cent, with the discount for non-energy businesses likely to be higher.

An alternative view is that franking credits are fully valued, or are not discounted at all.[43] This view lies outside the range of market value evidence examined by the Australian Energy Regulator, calling into question its validity.[44] If franking credits are fully valued, then Australian businesses would be unaffected by changes in the company tax system. The evidence clearly shows otherwise.[45] Finally, if franking credits are fully valued, most credits would be refunded to individual taxpayers, and the cost of reducing the company tax rate would be much smaller than otherwise thought — arguably *strengthening* the case for cutting the tax.

Recent Australian evidence shows company tax cuts have an impact even on smaller companies, where it would be expected that franking credits are most highly valued, because the shareholders are most likely to be Australian taxpayers. Smaller Australian businesses responded to the recent reduction in the small business company tax rate by increasing investment and hiring more staff.[46] Put simply, domestic shareholders would benefit from a cut in the company tax rate.

With a lower company tax rate, foreign owners of Australian registered companies would pay less tax. However, it is much more important that a lowering of the company tax rate provides benefits to Australians through growth in output, employment and wages; as outlined earlier. To propose that these benefits to Australians should be foregone simply because foreign investors will also gain, is akin to arguing that international trade is bad because both domestic buyers and foreign sellers are advantaged. In addition, if a company tax cut is phased in, the benefit to foreign investors would be reduced. This is because the foreign capital invested at the old higher tax rate depreciates over time, so the tax cut benefits a smaller installed capital base.[47]

4.2 An investment allowance

An investment allowance involves an immediate tax deduction or incentive for new investment by companies and has been offered as an alternative to company tax cuts. Both these policies lower the corporate effective tax rate and the tax burden on investment, so it is unsurprising that both policies are likely to boost investment.[48] The policies are to some extent complementary and could be implemented together.

However, on many criteria, a company tax cut is preferable to an investment allowance. An investment allowance lowers effective tax rates but doesn't affect the headline rate, which has an adverse effect on business decisions.[49] A relatively high headline rate advertises Australia as an unfriendly destination for investors, and encourages profit shifting to lower-taxed jurisdictions.

A company tax cut provides uniform incentives to different investment decisions, while an investment allowance has uneven impacts — providing divergent incentives for asset investment depending on how long an asset lasts, and likely failing to encourage investment in many intangibles, which are growing in economic importance.[50] Some allowance proposals feature distortionary treatment of different assets further distorting the incentive to invest.[51]

In addition, an investment allowance has substantially higher up-front budget costs; particularly compared to a company tax cut that is phased in.[52]

The differential rate of company tax levied on companies with an annual turnover of less than $50m also causes distortions in investment incentives. Reducing the company tax rate to the same level for all businesses would simplify the tax system and remove the effective tax rate imposed on companies just below the $50m tax threshold. Relying on an across-the-board company tax rate cut rather than investment allowances and differential rates would make the tax system less complicated, requiring fewer anti-avoidance provisions to stop businesses churning assets to claim the allowance or avoid the turnover threshold.

4.3 Static and dynamic impacts

A lower company tax rate should not be simply compared with the continuation of the current tax rates of Australia and other countries. For instance, if the Australian company tax rate was to be held at 30 per cent, the nation's international competitive position is likely to continue to decline given the clear and prolonged international trend to lower tax rates over time (See Figure 3). A reduction in the Australian company tax rate may only temporarily avoid a decline in competitiveness, with Australia's competitiveness restarting its slide if competing nations continued to adjust their company tax rates downwards over time. The benefits of a company tax cut will be immediate where a cut occurs to counteract a flight of capital to countries with lower tax rates.[53] Australia could well be experiencing this problem now, given the major declines in business investment (see Figure 1) and foreign investment (Figure 2).

Even in a situation where there is no need to prevent capital flight, the benefits of a company tax cut will be experienced quickly, with half the benefit expected within 10 years, based on dynamic models of the economy.[54]

4.4 The budgetary costs of a lower rate

A reduction in the company tax rate implies that government revenues would be reduced, putting further pressure on the budget. However, there are a number of factors that lessen the impact on revenues.

First, a reduced tax rate will increase economic activity. The increase in profits being earned means that the rate reduction is offset by an increase in the activity being taxed. Second, domestic investors will receive less franking credit on dividends paid by companies. Hence, the aggregate amount of tax paid by companies and their domestic shareholders remains the same, independent of the company tax rate. Third, with greater economic activity and higher wages stimulated by a reduced company tax rate, personal income tax payments made by Australian workers would be increased. In addition, where mining activities are stimulated, companies will pay higher royalty charges to state governments. Factoring in the boost to economic activity, Treasury has estimated that the costs of the company tax cut will be reduced by a third to a half over time.[55]

Treasury's estimate of the revenue dividend is likely to be an underestimate as it does not include the increased capital gains tax revenue from any stock market 'bump' caused by a tax cut, or the long-term benefits of increased innovation. The Treasury modelling also assumed full employment, thus excluding the likely personal income tax benefits arising from increased wages and employment.

5. Conclusions

Can Australia afford not to lower company tax rates? The trajectory of investment and the consequential declines in growth, productivity, employment and wages experienced pre-COVID19, coupled with the economic shocks created by the pandemic, suggest not. The COVID-19 crisis has most unusually forced governments to deliberately harm certain industries without compensation to protect the whole community. The impact of this government action has hit the private sector hardest. Economic recovery therefore critically depends on resuscitating business activity and encouraging greater foreign investment; an erstwhile international driver of Australian production.

In short, company tax cuts would provide the oxygen the private sector now needs to recover from the ill economic effects of the pandemic. To compete effectively with rival nations for mobile international capital — both now and into the future — a company tax cut from the current 30 per cent rate to 20 per cent is essential.

Providing tax relief to encourage business investment should therefore be central to the federal government's fiscal response to the COVID-19 crisis, as a means of generating jobs and economic growth.

The post COVID-19 world will be different. In that new environment, our economy must be structured to make the most out of the resources available. New ways of producing new products will need to be found. Entrepreneurship will be vital to the process of adjustment that will be required. Profit is the return to investment and entrepreneurial risk-taking. Making sure the profit signal is transmitted loud and clear — with less interference from the static of the tax burden — will be critical for our economy to grow and become more flexible, more resilient to future shocks, and stronger.

A company tax cut implies reduced budget revenue, other things equal. However, any revenue fall would be mitigated by the stimulatory effects reduced company tax would have on the broader economy in raising other forms of revenue, including goods and services and personal income tax. Company tax revenue would likely also rise in the future to the extent that foreign companies, currently deterred by the existing uncompetitive company tax rate, establish new operations here. Meanwhile, revenue lost due to Australian-based companies, domestic and foreign owned, relocating abroad would be curtailed.

Balancing the budget will nonetheless require offsetting cuts to wasteful government outlays.

A comprehensive external 'root and branch' review of existing public spending programs of all levels of government along the lines of the Henry Tax Review could be instigated immediately as a blueprint for public expenditure reform. [56]

An obvious candidate for expenditure review of particular relevance, in this context, is the billions spent on assistance to a range of industries. While company tax cuts benefit business and the whole economy, industry assistance is inefficient and selectively benefits some businesses at the broader economy's expense. [57]

Other policies that should be examined include:

- removing duplications of functions across the different levels of government, especially in health and education;
- including the family home in the means test for the Aged Pension, with appropriate transition arrangements;
- restricting public sector employee growth nation-wide; and
- reducing the regulatory burden of both red and green tape on the economy.

In addition, budgetary savings should be made through imposing a pay cut (either directly or via an income tax levy) on public sector employees. Private sector firms and employees have largely borne the cost of the COVID19 lockdown. In contrast, people working in the public sector have been left largely unscathed. This justifies a public sector pay cut — or at least an extended pay freeze — on equity grounds alone.

Expenditure reduction in these areas would counter budgetary pressure caused by the company tax cut. The only genuine Australian fiscal consolidation episodes in living memory were undertaken by the Hawke-Keating-Walsh and Howard-Costello teams. After both episodes the economy flourished.

In sum, at the macroeconomic level, Australia's internationally uncompetitive company tax rate deters investment, domestic and foreign; which adversely affects productivity, employment and wage growth. On efficiency and equity grounds, the case for cuts to the company tax rate is strong. Along with abolishing regulations that stymie investment and innovation, company tax relief would breathe new life in to the economy by lightening the burden of government on the supply side of the economy — where real wage-enhancing investment decisions are made and most jobs are created.

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35 With state taxes included, the average rate rises to 25.8 per cent.

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40 The effective average tax rate is the average tax contribution a firm makes on an investment project earning above-zero economic profits; while the effective marginal tax rate measures the increase caused by tax in the breakeven rate of return required by investors. See OECD (2019) Corporate Tax Statistics, First edition.

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46 AlphaBeta (2018) op. cit. The report only examined the immediate impact of the tax cut, so the longer term benefits are likely to be larger.

47 For example, consider a company tax cut phased in over ten years. Given that the average age of all capital stock in Australia is about 14.5 years, the average asset owned today will be over 60 per cent depreciated by the time the company tax cut is fully implemented. That means the tax cut gain enjoyed by a foreign investor on the average asset is around one third of that which would occur from an immediate cut.

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55 See Kouparitsas, M., D. Prihardini and A. Beames (2016). "Analysis of the long term effects of a company tax cut", Treasury Working Paper 2016-02.

56 The National Commission of Audit provides a starting point at federal level, although a new review should be more comprehensive in examining local, state and federal spending against a set of public finance principles.

57 Makin, A. (2020). A Fiscal Vaccine for COVID-19, CIS Policy Paper, June, for related discussion.

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Related Works

Tony Makin, *A Fiscal Vaccine for COVID-19* (CIS Policy Paper 30, June 2020)

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