Submission to the Productivity Commission
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The Productivity Commission's report proposes a new cash-flow tax be introduced, which gradually replaces the corporate income tax system over the longer term. In theory, a cash-flow tax (CFT) and an allowance for corporate equity (ACE) are equivalent economic rent taxes. In practice however, the transitional costs associated with the implementation of a CFT, aimed to eventually replace the corporate income tax (CIT), are much greater compared to an ACE. Indeed, based on the experiences of other countries that considered introducing a CFT, the transitional costs proved too costly and risky, outweighing the potential investment incentives engendered.

The Productivity Commission's report presents a biased, overly optimistic, and unrealistic, assessment of the implementation challenges associated with the introduction of an R-base CFT over the longer term. In doing so, it underestimates and misrepresents the fiscal costs associated with the transition away from a CIT and towards a CFT in the future. In the final report, it would do better to recognize, discuss, and estimate the transitional costs of transitioning towards a full cash-flow tax over the longer horizon, so as to more transparently present all of the potential costs and benefits to Government.

Fuller discussion of the associated transition costs of implementation (to government revenue and business certainty) of an R-based CFT would be advised for the final report, especially since the transition costs of alternative corporate tax systems are more fully discussed in the interim report.

My comments below are largely drawn from:

Sobeck, K., Breunig, R., and Evans, A. (2022), Corporate income taxation in Australia: Theory, current practice and future policy directions, Tax and Transfer Policy Institute (TTPI) Policy Report No. 01-2022, Canberra, Australia.
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https://crawford.anu.edu.au/ttpi-reports

Transitional measures for undepreciated assets and debt interest

If an R-base CFT is adopted and replaces the CIT over the longer term, there are two potentially costly transitional issues: how to manage undepreciated assets, as well as the financial cost of debt interest for leveraged companies. Since the PC largely adopts the Garnaut et al. (2020) model as its recommendation, a brief summary of that paper, as well as a discussion of our criticisms is copied below from Sobeck et al. (2022):

“Garnaut et al. (2020) simulate the introduction of a national R-based and source-based cash-flow tax for Australia with a separate tax for the financial sector (the financial services income tax: FSIT). The FSIT would apply at 30%, the same rate as the proposed R-based cash-flow tax rate. Companies could choose to switch from the current corporate income tax system to the CFT at any point over a 10-year period. They would be obligated to switch to the CFT after year 10 in the absence of a prior change. The authors estimate the introduction of an R-based tax would generate more corporate income tax revenue than the current corporate income tax system because of revenue gains from taxable corporations with international dealings and the boost to private investment induced from replacing the corporate income tax system with a CFT.

While the authors estimate the proposed revenue gains from a CFT, they do not fully discuss or estimate associated transitional costs. They do not discuss how remaining undepreciated assets are treated when companies make their switch. If all remaining depreciation allowances are allowed to be deducted prior to the irrevocable switch, the government will incur revenue losses not accounted for in their modelling. If the authors expect companies to bear the cost of the change by denying deductibility of remaining depreciation allowances, they neglect to discuss the implications. Companies that invest in assets with very long effective lives would likely wait until the 10 year period ended to switch (to fully take advantage of the depreciation allowances) and might also defer large investments until they enter into the new system. The transitional implications for government tax revenue and companies of disallowing debt interest deductions, particularly for heavily leveraged companies, is not discussed in the modelling.”

If the PC is advocating a CIT to CFT switch over the longer run, a discussion of these transition costs is advised in the final report to better understand the longer-term implications for government revenue, as well as for business certainty.

International tax implications

Omitted from the PC’s interim report is a discussion of the reasons for which other countries have opted to forgo a CFT. One important factor highlighted by both Norway and New Zealand related to the potential for double taxation and the countries’ potential (in)ability to comply with current tax treaties and international obligations.

If the PC is advocating a CIT to CFT switch over the longer run, it is advised for the final report that they seek preemptive advice about the potential international tax landscape implications. Indeed, if multiple bilateral tax treaties need to be renegotiated as part of the transition, this should be preemptively identified and discussed, especially if it leaves businesses potentially facing double taxation.

Other countries' experiences

One reason Sobeck et al. (2022) advocate for an ACE, rather than a CFT, is based on international experience. The consequences of introducing an ACE are partially understood because there are a number of countries that have actually introduced one. By contrast, no country internationally has ever introduced a national CFT. Some of their reasons for not introducing a CFT are included below, extracted from Sobeck et al. (2022):

"These considerations, among others, discouraged Norway and New Zealand from adopting cash-flow taxes following reviews of their corporate tax systems. In Norway, the Scheel committee considered replacing the corporate income tax with a CFT in its review in 2014. It decided against this proposal for several reasons. First, international differences in definitions and the treatment of income and costs could increase the likelihood and potentially the magnitude of double taxation. This was of particular concern to a small open economy aiming to attract more investment. Second, implementing a CFT while continuing to comply with current tax treaties and international obligations would be challenging from a legal standpoint. Finally, tax revenue would be more volatile and countercyclical, falling in times of investment expansion (large cash outflows) and increasing in periods with lower investment (smaller cash outflows).

New Zealand also considered implementing a CFT in 2001, and again specifically for small business in 2002, neither of which eventuated. The transitional obstacles featured among challenges associated with implementation. In particular, new investments made by firms would receive an immediate deduction (in the form of large cash outflows) under a CFT, while investments made prior to its imposition would have to forego future years of tax-deductible depreciation. The 2002 review proposed three options with differing winners, losers and consequences. Allowing firms to deduct the remaining undepreciated value of pre-existing assets upon transition to the CFT would have resulted in significant tax revenue loss for the government and higher income taxes on workers. Concerns emerged about future tax evasion where companies structured large investment cash outflows in New Zealand and future cash inflows from those investments in other jurisdictions. Finally, a proposed CFT exclusively for small businesses was dropped over implementation concerns about growing companies that would need to transition from a CFT small business scheme to a traditional corporate income tax scheme as a large business."

If the PC is advocating a CIT to CFT switch over the longer run, it would be advised to justify why the lessons learned from Norway and New Zealand are not applicable, or are of less relevance in the Australian context.