Comments on Pillar Number 1

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1. Rephrase the story for reform of company tax

I believe the presentation of arguments for the introduction of a cash flow tax needs a refocus. Key point is to shift the tax mix to lower taxation of the normal return on investment to higher taxation of the above normal return.

The key feature of the tax reform proposal is to shift the mix of taxation of company income tax from the current company income tax to a cash flow tax. The current company income tax applies a common tax rate to both the normal rate of return and to the above normal rate of return on funds invested. The normal return refers to compensation for saving and the deferral of income available for future consumption. The above normal return refers to additional compensation, including for relatively higher return natural resources, including land, minerals and energy, profits generated by the exercise of market power, and short-term benefits of successful new technology. The cash flow tax base applies only to the above normal return.

The Pillar 1 company tax reform proposal is to increase the effective tax rate only on above normal returns to fund a reduction in the effective tax rate on normal returns. The reform package is designed to be roughly aggregate revenue neutral (because of the current budget constraints) and to minimise redistribution of vertical equity for Australian shareholders.

National productivity and efficiency benefits of the tax mix change involve the following. Investments which generate above normal returns are less geographically mobile than investments which generate only normal returns. The supply of funds for investment in Australia is more elastic than the supply of domestic source funds, and company tax rates in many countries have been lowered over recent years.

The above argument for greater efficiency of taxation of companies and for a stimulus to national productivity is more substantive than the stated argument of immediate expensing of 5% of new investment outlays by small and medium size companies. While large companies (or all companies) should prefer a comprehensive cash flow tax to the company tax, for large companies the reform package retains the current company tax at 30% on normal and above normal returns and it adds a 5% tax on above normal returns. Most small and medium companies benefit from the lower company tax rate on normal returns: and only a few with a very high share of above normal returns pay more tax in aggregate.

I suggest the story would be easier to sell if the tax mix change applies to all companies, that is a lower tax rate on the normal return and a higher rate on the above normal return. And investment demand is more elastic for projects which primarily earn only the normal return. Point 3 provides examples.

2. Redistribution and equity effects of the tax reform proposal

Maybe add some discussion of the tax redistribution and equity effects of the proposed change in the mix of company income tax from a lower burden on the normal return to a higher burden on the above normal return.

To understand the equity effects, I include the links between the saver who provides funds for a company and the company as investor. Savers include domestic, and then individuals, super funds and other businesses, and non residents, and then shareholders who provide equity funds and others who provide debt funds.

Consider first a situation with no investment or other production decision responses to the proposed tax reform package.

(i) Small companies (< $1 billion revenue per year) with lower company tax rate and 5% CFT

  (a) Resident shareholder funder and only normal return (so CFT does not apply). Lower company tax rate (30% or 25% to 20%) and no CFT means less tax paid, and a reduction of imputation credits. For income distributed as dividends, under the imputation system, the reduction of company income tax and reduction in imputation credits will be offset by higher income taxation of the saver. For retained earnings, the lower company income tax will flow through to additional capital gains and additional CGT on realised transactions. In net a small gain for the resident shareholder.

  (b) Resident shareholder and company income which includes an above normal return component. Other than for companies with a share of above normal returns more than double the share of normal returns in total company income, the extra CFT burden (5%) will be less than the reduction of company income tax. In net, a smaller net gain for resident shareholders under imputation system than for (a).

(c) Non resident shareholders. Benefit from lower company income tax by rate reduction if no above normal income. If they pay some CFT on any earned above normal income, a reduction in aggregate tax paid unless the above normal return is double the share of the normal return.

(d) Debt funders. Effective tax burdens on savers do not change.

(ii) Large companies (> $1 billion revenue per year) with constant company tax rate (30%) and addition of the 5% CFT

(a) Resident and non resident shareholders and only normal returns. No change in taxation for the company or for shareholders.

(b) Resident shareholders and company income includes above normal returns. Increase in aggregate income tax paid. Likely some of the increase goes to a larger imputation credit and an offsetting reduction of shareholder income tax payment.

(c) Non resident shareholder and company income includes above normal returns. Extra tax collected (namely the CFT) from the shareholders.

(d) Debt funders. Effective tax burdens on savers do not change.

For companies and funders whose effective tax burdens change as discussed above, investment and saving decisions can be expected to change. Those who gain invest and save more, and those with higher effective tax burdens reduce or shift their investments and saving. These decision changes will have second round redistribution effects, including wages and product prices. Quantification of effects with computable general equilibrium models such as Murphy and Victoria University.

3. An alternative reform package

Potential challenges to the PC proposal include the artificial split of company tax rates by firm size and the concern that all the higher taxes fall only on large businesses. Alternative options include the following.

A flat 10% cash flow tax on all companies to fund a 5% point reduction of the corporate tax rate for all companies. As, I suspect, most of the economic rent is gained by large companies, most of the additional tax burden will fall on large companies, but some on medium size companies. Proposal effects:

(a) Roughly aggregate revenue neutral.

(b) Since the CFT draws on current taxpayer data, there is a negligible increase in tax administration and compliance costs.

(c) As discussed in section 2 above, limited redistribution effects for resident shareholders, and in aggregate for non resident shareholders, but losses (gains) if funds in a large company earning above normal returns (mostly normal returns).

(d) National efficiency gains would flow from the tax mix switch from taxation of normal returns to above normal returns.

A larger reform package would have a 20% point CFT to fund a 10% point reduction of the company income tax.